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Special Issue:
***Forces for Change
in the 1990's***

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Summary

As the decade of the 1990's begins, world agriculture and its economic environment face contending forces for change. Some are old forces in new guises, like the external debt problem, which has been with us for more than 10 years but which assumes new shapes as economic growth and trading patterns gradually shift. Some of the forces are entirely new, however, like the dramatic changes in Eastern Europe and the USSR, and have the potential to radically alter, in a short space of time, ongoing processes like European integration and world trading patterns themselves.

This special issue of *World Agriculture Situation and Outlook Report* is devoted to analyzing and assessing some of these forces for change in the 1990's. The authors present the results of their research and experience on how these forces hold the potential to shape world production and trade.

Each of the first five articles deals with some aspect of the negotiation of conflicting national interests. The first article looks at the dynamics of the multilateral trade negotiations of the Uruguay Round, which are due to wind up by the end of the year, comparing the proposals advanced by the United States and its trading partners. Much more is at stake here than access to markets for agricultural products, as some of the other articles point out. Failure to reach mutually satisfactory agreements in the Round would have serious repercussions on the prospects for liberalized agricultural

trade, spurring the proliferation of preferential trading arrangements, making it easier for countries to use food safety regulations as barriers to trade, and exerting other effects. One article deals with the project for European Community (EC) integration known as EC 1992 and some of its likely effects on agricultural trade. Another looks at the mixed record of international commodity agreements by which trading nations have attempted to manage trade in particular commodities.

A second set of four articles examines current developments in four of the world's major trade actors—Eastern Europe, the USSR, China, and Japan—and sees what the future might hold for them and for their trading partners. Developments in Eastern Europe and the USSR, in particular, have drastically changed the political and economic environment in which world agriculture operates, and are generating new production and trade patterns.

The three final articles examine unresolved issues from the 1980's. These are, respectively, the negative impact on economic growth of closed systems of economy, politics, and civil affairs; the transition to convertible currencies in Eastern Europe and the USSR as the countries there seek closer integration in the world economy; and the drag on world trade exerted by external debt.

Dynamics of Trade Negotiations

by

Stephen L. Magiera and Martin Johnson*

Abstract: The Uruguay Round has six months to produce a generally acceptable formula for meeting its objective of achieving greater liberalization in agriculture and bringing all measures affecting import access and export competition under strengthened and effective GATT rules. This article examines the dynamics of the multilateral trade negotiations and argues that an agreement on agriculture may be a prerequisite for a successful Round in general.

Keywords: Agricultural trade, General Agreement on Tariffs and Trade (GATT), Uruguay Round, trade liberalization, protection, trade distortion, tariffication, rebalancing.

The Uruguay Round of multilateral trade negotiations began with high expectations in September 1986. The Punta del Este Declaration, which began the Round, states that the objective of negotiations on agriculture is to "achieve greater liberalization in agriculture and bring all measures affecting import access and export competition under strengthened and operationally effective GATT rules and disciplines." The declaration thus signals a strong international commitment to make significant progress on agriculture in the negotiations.

Agriculture's Exceptional Treatment

Although agriculture has been a contentious issue in previous Negotiations, agricultural trade has been largely exempt from the rules and disciplines of the General Agreement on Tariffs and Trade (GATT). Previous negotiations have been very successful at liberalizing trade in manufactured goods by reducing tariff rates. Although fewer agricultural tariffs are bound in the GATT and tariff rates are high, nontariff barriers (NTB's) are far more important to agricultural trade than tariff barriers. Although NTB's were addressed in the 1970's during the Tokyo Round, the GATT has been unsuccessful in preventing their proliferation.

In addition, there are several exceptions and omissions to GATT rules that are particularly applicable to agriculture. Article XVI of the GATT prohibits export subsidies, but subsidies on primary products (including bulk agricultural products) are allowed, provided they do not result in a country's obtaining an "inequitable" share of world trade. The concept of "inequitable" market share has never been clarified, and has thus proven ineffective in disciplining the use of export subsidies.

Similarly, Article XI prohibits the use of nontariff import barriers, such as import quotas, except when used in conjunction with domestic production or marketing controls. Over the years, there has been a proliferation of import quotas

under this exemption. Also, the United States obtained a waiver to Article XI and may apply quotas even when domestic supply controls are not in effect.

Finally, many so-called "gray measures" cause adverse trade effects and are not formally covered by GATT rules and disciplines. This makes their elimination, or even reduction, that much more difficult. Examples are the European Community's (EC's) variable levies, voluntary export restraints, and many activities of state trading agencies.

Major Issues for the Round

In December 1988, GATT member countries met in Montreal to review the midterm progress of the Round and to set the agenda for its completion in December 1990. Agreements were reached in 11 of 15 negotiating groups, but could not yet be obtained in agriculture, intellectual property, safeguards, or textiles. Agriculture was a particularly contentious issue because countries could not agree on the precise objectives for the agricultural negotiations. A compromise was finally reached in April 1989, when language calling for the "elimination" of trade distortions was replaced by language calling for "substantial, progressive reductions in agricultural support and protection, sustained over an agreed period of time."

The midterm review pointed to many issues that remain unresolved after over two years of negotiation which will significantly affect the outcome of the negotiations. Foremost of these is the extent to which agricultural trade should be liberalized.

The United States and the Cairns Group 1/ of exporters desire the elimination of all trade-distorting agricultural policies over a 5- to 10-year period. Although willing to negotiate reductions in support to agriculture, the EC has been less specific about the reductions it would accept and has adamantly opposed the elimination of all trade-distorting policies. (See box) It proposes short-term market management to

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stabilize markets and links future support reductions to conditions on world markets. Presumably, no reductions in support would be necessary if world market prices strengthen. Finally, Japan, South Korea, and

Agricultural Issues and U.S. and EC Negotiating Positions

<u>U.S.</u>	<u>Issue</u>	<u>EC</u>
Toward 100%	Reduction in trade-distorting support	Toward 0%
Toward 100%	Price transmission (tariffication)	Toward 0%
Toward 0%*	Rebalancing	Toward 100%
Specific policy instruments	Negotiating approach	Aggregate measure of support

*If the negotiations achieve a 100% reduction in trade-distorting support as proposed by the United States, markets would automatically be rebalanced.

several other European countries argue that the problems of agricultural trade are primarily due to the policies of exporters. These countries would eliminate export subsidies but allow policies which promote self-sufficiency in basic food stuffs.

A second major area of disagreement concerns the types of policies countries may use to support their agricultural sectors. Tariffs are the preferred policy instrument under the GATT because, unlike quotas and other NTB's, they do not fully insulate domestic producers from the world market. Also, NTB's cause greater instability in world prices and place an added burden on market-oriented countries during periods of chronic surpluses. During such periods, market-oriented countries must cut back production, while production in countries protected by NTB's is left unchanged or even expanded.

Also, tariffs are transparent and thus easier to discipline and negotiate under the GATT. Price distortions caused by tariffs are determined by tariff rates which are fixed over time. Once bound in the GATT, they can be increased only in certain circumstances and represent fixed targets for future negotiated reductions. On the other hand, price distortions caused by NTB's which insulate producers from world markets vary from year to year and are difficult to negotiate. Such NTB's, of which the EC's variable levy is just one example, represent a moving target for negotiation. Disciplines could be placed on their use, but the protection

afforded by such policy instruments cannot be fixed in the GATT without fundamentally changing the nature of the policy instruments themselves.

In November 1988, the United States proposed that all NTB's, including import quotas and variable levies, be converted to their tariff equivalents. During the transition to tariffs, countries would establish tariff-free quotas in order to guarantee market access. The U.S. "tariffication" proposal would solve many of the difficulties inherent in the agricultural negotiations and would be a major step towards bringing agricultural trade under GATT rules and disciplines. Under the proposal, world price changes would be fully transmitted onto domestic markets for imported commodities.

Tariffication would also require significant changes in the types of policy instruments used to support farmers. It would eliminate import quotas that exist in the United States and other countries under Article XI. Other countries are less clear about Article XI, but many presumably hope to retain it. Tariffication would also severely restrict the operation of many state trading organizations and would require fundamental changes in the EC's Common Agricultural Policy (CAP). The EC has countered with its own version of tariffication which contains a variable component and substantially insulates its producers from world market signals. The U.S. and EC positions in this regard are very similar to their positions 25 years earlier in the Kennedy Round of negotiations.

The EC has proposed "rebalancing." Essentially, it seeks to trade cuts in the high level of import protection in the cereals sector in return for increases in the tariff level for nongrain feeds. Currently, most nongrain feeds are imported into the Community at tariff rates which were bound at zero or very low levels during the Dillon Round of the 1960's. These nongrain feeds compete with higher priced EC feed grains, thereby adding to EC grain surpluses and the cost of surplus disposal. Rebalancing would allow the Community to close a major loophole in the CAP and it has linked concessions on the U.S. tariffication proposal to rebalancing. Some of the commodities affected by rebalancing—oilseeds and corn gluten feed for example—are of particular importance to U.S. trade.

Because governments differ on the long-term goals of the Round, they also differ on the approach to the reform process. Under the U.S. proposal, countries would submit schedules of changes in specific policy instruments. These schedules would lead to the eventual elimination of the policies.

The EC opposes negotiation of specific policy instruments and would focus instead on an aggregate measure of support

to agriculture. Under its proposal, countries would retain control over their policy instruments for individual commodities, with commitments based on aggregate support to agriculture. Countries would then have more flexibility in manipulating individual policy instruments to meet aggregate support commitments.

Underlying the different proposals are different national philosophies concerning the role of government in agriculture. By distorting price incentives, all forms of protectionism/support for one commodity indirectly tax other commodities. When policies are first implemented, the indirect tax often goes unrecognized. When recognized, however, the taxed sectors are likely to press for relief or compensation. The United States and Cairns Group would eliminate the source of the taxation. Others would offset the tax by adding a new layer of policies. For example, some countries suggest that the exceptions under Article XI be extended to processed products. Import quotas under Article XI effectively tax processors, who may then demand offsetting protection for their products. Another example is the EC's proposal to raise protection on nongrain feeds. While this would close a major loophole in the CAP, it would also shift some of the costs associated with the CAP for grains to third-country suppliers of these feeds.

Why Multilateral Negotiations in the GATT

The impetus for major reform of the agricultural trading system arises from the structural market surpluses, heightened trade tensions, and burgeoning costs to governments of farm support that became evident during the 1980's. In recent years, agricultural trading patterns have been determined as much by government budgets as by underlying economic forces.

While countries have differing philosophical views on resolving agricultural trade problems, a multilateral solution will always be preferred to unilateral action by any one country. With multilateral action, the burden of adjustment is shared by many countries. The tradeoff is that countries give up some control over their domestic policies by agreeing to subject their policies to international rules and disciplines.

The EC's spending on agriculture accounts for 70 percent of its budget. The Community is accustomed to managing its domestic markets and, in order to bring spending under control, it recently implemented production constraints on dairy and grains. 2/ These commodities account for over 60 percent of EC agricultural spending and are now major EC exports.

On the international side, the EC prefers the direct analogue to its domestic policies—international supply management and negotiation over market shares. Clearly, if its proposal

were accepted, the production cutbacks necessary in the EC alone would be far less.

In some ways, recent EC policies are not so very different than former U.S. policies. In periods of world excess capacity and low world prices, the United States has unilaterally cut back production in order to support prices and reduce government outlays for deficiency payments.

However, U.S. views on market management are very different from those of the EC. When the United States unilaterally reduced production in the past, other countries were able to capture markets for U.S. exports. Furthermore, production controls led to inefficient regional and commodity production patterns. As a result, the United States has gradually allowed producers more flexibility in their planting decisions while continuing to require them to take land out of production.

From the U.S. perspective, international market management would not only freeze production inefficiencies internationally, but the negotiations would necessarily be based on recent production patterns, which are themselves distorted by previous policies. Also, short-term solutions to market surplus problems, as suggested by the EC, would do nothing to improve market access. If all importing countries were to achieve food self-sufficiency, there would be no international market for exporters to share.

The proposals tabled by the United States and the Cairns Group focus on the sources of trade distortions—border protection, export subsidies, and internal domestic subsidies. Their ultimate objective is to open markets and establish a level playing field for competition within those markets.

Studies of major trade reform of this type suggest that it will lead to significantly higher world prices for most agricultural commodities, reduce budgetary costs for agricultural support, and enhance economic welfare and accelerate economic growth in many countries. They also predict that incomes of producers of highly protected commodities will decline. But the U.S. and Cairns Group proposals would allow offsetting income support to farmers provided that this support is not linked to farmers' production decisions.

However, these income losses will be far less, and may not even occur, if reform is undertaken multilaterally. First, the world price increases from multilateral reform will offset the declines in domestic prices due to the removal of a country's own domestic programs. Second, a fundamental premise of the GATT is "reciprocity." If one country places disciplines on its domestic policies, other countries are expected to reciprocate with similar disciplines of their own, thus leveling the playing field.

Reciprocity also implies that whatever one country gives up will at least be matched by concessions by other countries. In fact, concessions by the rest of world are likely to be much greater. This is simply because production and the protection afforded in the rest of world are greater than in any one country. 3/

Trade studies measure income losses based on initial concessions adjusted for improvements in world prices. What they generally do not capture are the longer-run impacts of open markets and level playing fields. Competitive producers in all countries, even importing countries, are free to expand sales into all markets. It is impossible to predict where such expansion will occur.

The potential gains to any one country are likely to be far greater if the negotiations are comprehensive. Indeed, the Uruguay Round consists of 15 negotiating groups and encompasses many commodity sectors other than agriculture. Trade liberalization in one sector reinforces and increases the gains from trade reform in other sectors. Consequently, a country which views itself as losing from agricultural trade reform may nevertheless be a net gainer when all sectors are liberalized. 4/ Further, its agricultural losses will be smaller because, just as agricultural protectionism taxes other sectors, protectionism in these other sectors taxes agriculture.

Other than the general disarray of agricultural markets, perhaps the strongest motivation for a successful negotiation on agricultural trade is the fact that the Uruguay Round negotiations are comprehensive. Many developing countries are unlikely to sign off on agreements covering intellectual prop-

erty rights and other issues of concern to the industrialized countries, unless a significant agreement on agriculture is obtained. Furthermore, the United States and many other countries have stated that they will only accept a comprehensive package that includes reforms in all sectors. Thus, a successful agreement on agriculture may be a prerequisite for a successful Round in general.

Notes

1/ Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Hungary, Indonesia, Malaysia, New Zealand, Philippines, Thailand, and Uruguay.

2/ Dairy is one of the commodities most in surplus in the industrialized countries. In order to keep these surpluses under control, many of the industrialized countries have implemented production quotas. In all cases, these production quotas were meant to be temporary. In no case, has a quota been eliminated.

3/ Assume three countries each with a protection rate of \$1 per unit produced and 100 units of production. If all protection is eliminated, country A gives up \$100 ($\1×100) in protection for its producers. The rest of world gives up \$200 ($\$1 \times 100 + \1×100).

4/ Japan, for example, may view itself as losing from agricultural trade reform but can expect to gain from liberalized manufacturing trade. In contrast, Australia stands to gain from multilateral trade reform in agriculture, but may be expected to give up its high protection on automobiles and other manufactured commodities.

EC 1992: Economic Integration and World Trade Effects

by
Walter Gardiner, Steve Neff and David Kelch*

Abstract: As the EC's program to complete the internal market moves toward its Dec. 31, 1992 deadline, barriers to a truly common agriculture—the agrimonetary system, national quotas, and technical regulations and standards—are being challenged. Liberalization of the EC's internal market implies more competition and opportunity for those doing business in Europe. In agriculture, however, political resistance to cutting producers' support prices and eliminating border taxes and subsidies between member countries will likely prevent any major reform until well after 1992 unless there is a successful conclusion in the GATT negotiations.

Keywords: European Community, EC 1992, Common Agricultural Policy (CAP), agrimonetary, dairy and sugar quotas, national subsidies, health and safety standards, GATT.

The European Community (EC) is in the fifth year of a legislative program to remove all existing internal barriers to free movement of goods, services, people, and capital by the end of 1992. The goal of the EC's 1992 program is to build a true common market as was intended by its architects 33 years ago. The reason for this initiative is the realization that physical, technical, and fiscal barriers have prevented the EC from achieving greater economic efficiency and economic welfare. While much world attention over the past decade has been focused on the dynamism of the Pacific Rim, new attention is now being focused on Europe and the changes occurring there as a result of the 1992 program.

Many countries outside the Community have taken a keen interest in its 1992 program because of their trade links and investments in Europe. Companies are scrambling to sort out a plethora of legislation resulting from 279 directives comprising the EC's program to unify all of its markets.

Concerns have been raised about some of the directives which could restrict market access in the future. The label "Fortress Europe" has been used by a number of non-EC officials to describe the potential market and investment environment that could emerge out of EC 1992 if third countries are not vigilant in monitoring the progress of the directives as they become part of EC commercial law. EC officials, however, have made numerous attempts to reassure their trading partners that the 1992 program will result in increased trade and investment opportunities for all.

Barriers to a Common Agriculture

Early in its development, the EC focused much attention on creating a common agriculture by eliminating numerous trade barriers which existed between the original six member

countries, and by establishing a set of rules for providing government support and regulating commodity markets. Since the foundations of the Common Agricultural Policy (CAP) were laid at the Stresa Conference in July 1958, various economic and political events have prevented the EC from achieving a truly common agriculture.

Obstacles currently impeding competition in the agricultural sector include:

- The EC's agrimonetary system which includes: special exchange rates for agriculture ("green rates") for converting EC policy prices into national currencies; and a system of border taxes or subsidies ("monetary compensatory amounts" or MCA's) to prevent "trade distortions" caused by the green rate mechanism.
- National quotas and income support related to production and trade of certain agricultural commodities.
- A wide range of technical regulations and standards that relate to products and services as well as animal, plant and human welfare.

The EC's Agrimonetary System

When the common market for agricultural products was being set up in the early 1960's, it was intended to provide common prices and free trade among member countries. Policy prices were to be set annually by the Council, the EC's decisionmaking body, and would be converted from a common monetary denominator into each country's currency by a set of agricultural conversion rates. These "green rates" were to be the same as the market exchange rates, meaning that any changes in market rates would be accompanied by changes in green rates so as to maintain the objectives of common pricing and free trade among EC member countries.

*Agricultural economists, Economic Research Service, USDA.

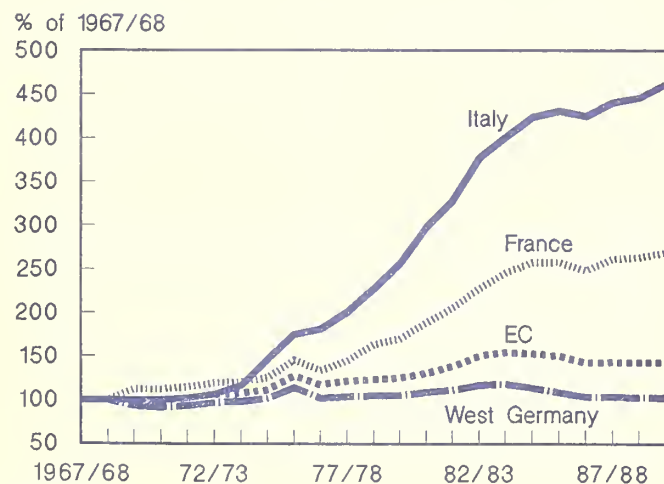
The breakdown in the Bretton Woods system of fixed exchange rates in the late 1960's and the unwillingness of member countries to allow exchange rate changes to be fully transmitted into their food and agricultural sectors have led to a set of green rates that differ from market rates and a system of border taxes and subsidies, or MCA's. Figure B-1, based on the EC's own statistics (4), shows how support prices among countries have diverged as a result of these mechanisms, which have, therefore, affected production decisions, resource allocation, marketing costs, consumption, stock levels, trade patterns and budget outlays. By supporting prices at higher levels in some countries, production has been stimulated and more resources have been employed in agriculture than in countries with lower levels of support (11, p. 206).

Border protection provided by MCA's maintains higher prices by keeping out cheaper imports from other member countries, but also from third countries, thus affecting trade patterns and reducing economic welfare. To the extent that the developments in the agrimonetary system have been unduly influenced by the strong currencies (the German mark and Dutch florin), the overall level of CAP prices for all countries is higher than it otherwise would be.

CAP prices denominated in common units (UA until 1978/79, ECU afterwards) increased until 1984/85, when the EC began to "discipline" prices, at least in ECU. This was the same year in which the EC introduced the "switchover mechanism" and its accompanying "correction factor" in an attempt to dismantle the MCA system and return to common pricing. However, prices expressed in national currencies, which account for the effects of the switchover mechanism and green rates of exchange, have continued to climb since 1984/85, though at a slower rate—2.2 percent per year for 1984/85-1989/90 versus 8.3 percent per year for 1978/79-1983/84, as shown in fig. B-2, based on EC data (4).

Figure B-1

EC Intervention Price Indices, Soft Wheat



High CAP prices have contributed to higher production, lower consumption, and greater self-sufficiency for EC agriculture (fig. B-3). EC self-sufficiency between 1960-64 and 1985 has risen from 84 to 127 percent for cereals, 100 to 133 percent for butter, 99 to 132 percent for sugar, and 97 to 102 percent for meat (15, 16). This, in turn, has reduced EC imports of agricultural products from third countries and increased exports, allowing for the effects of the EC's progressive enlargement, as shown in figs. B-4 and B-5, based on United Nations trade data (20).

While there are other factors that have influenced the levels of self-sufficiency and trade patterns in the EC, the agrimonetary system has played an important role. Eliminating the agrimonetary system with its green rates and MCA's by 1992 will be a formidable, if not impossible, task.

The monetary gaps that currently exist between countries as a result of the green rate system will necessitate major price adjustments if the EC's pricing system is to be harmonized by 1992. A decision to harmonize at the highest price level would entail price increases for all countries, which would run counter to the principles of the current GATT Round to freeze support at current levels. Harmonization at less than the highest level would entail price reductions for strong currency countries such as West Germany and the Netherlands and price increases for others. Price reductions will be strongly resisted and will likely require some form of compensation.

What is likely to happen by way of solving the agrimonetary dilemma in the near term is a tightening of current arrangements including (1) a faster alignment of green rates with market rates, (2) a gradual elimination of green rate differentials between commodities, and (3) direct payments or tax credits in place of MCA's.

Figure B-2

EC CAP Price Indices

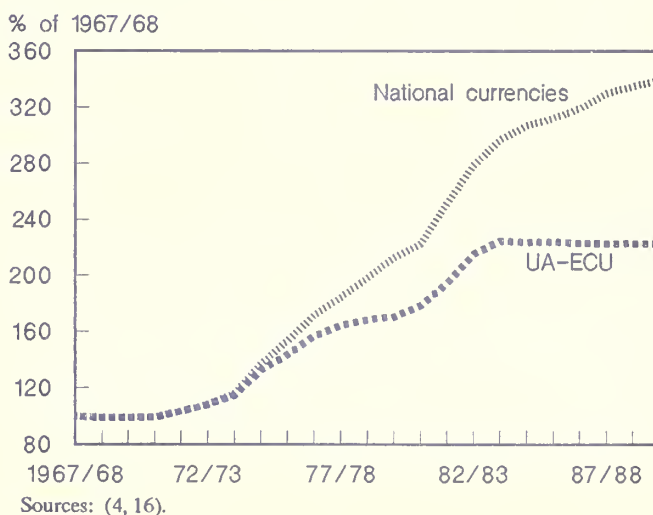
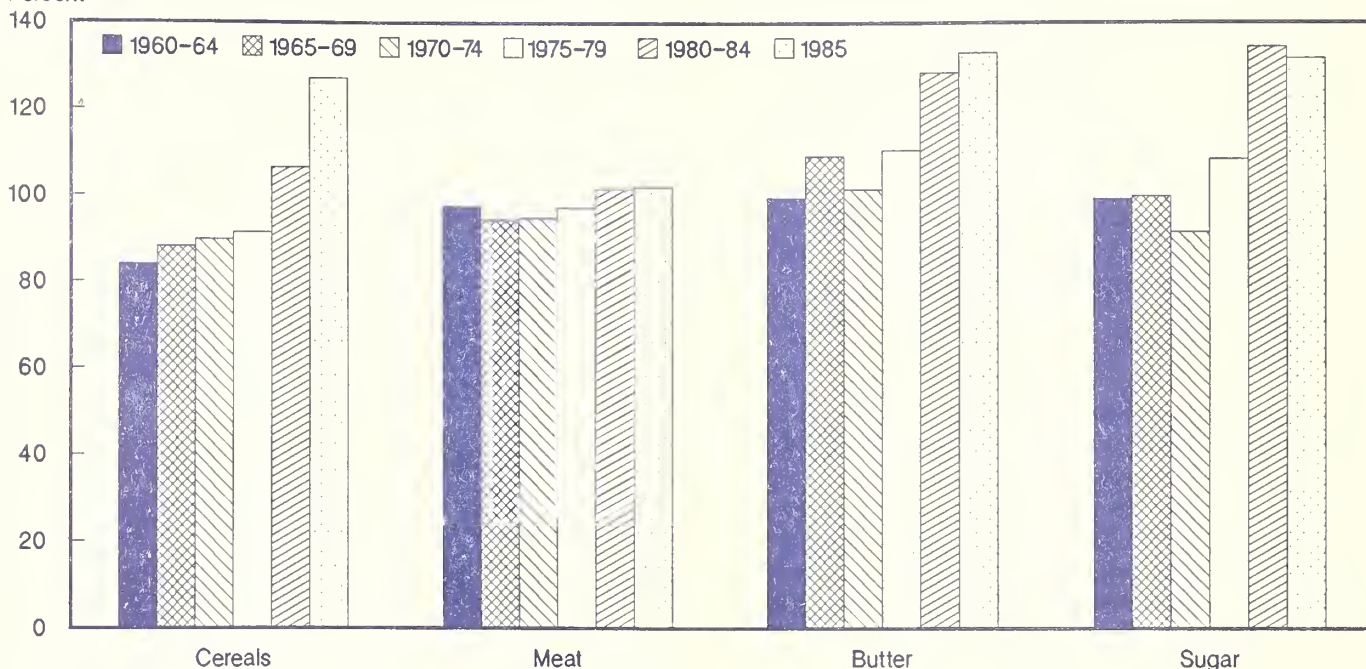


Figure B-3

EC Self-Sufficiency In Selected Commodities

Percent

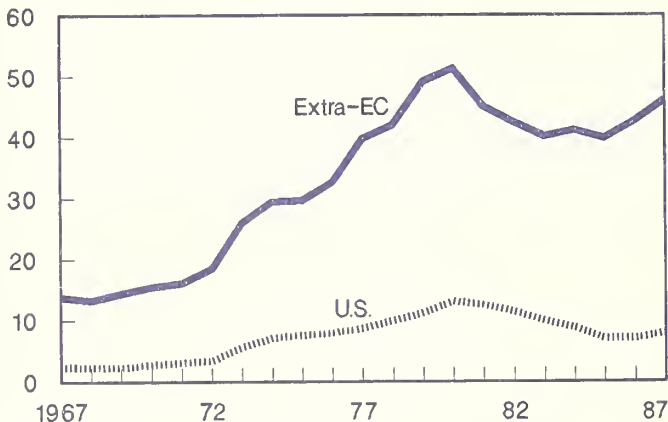


Sources: (15, 16).

Figure B-4

EC Agricultural Imports

\$ billion

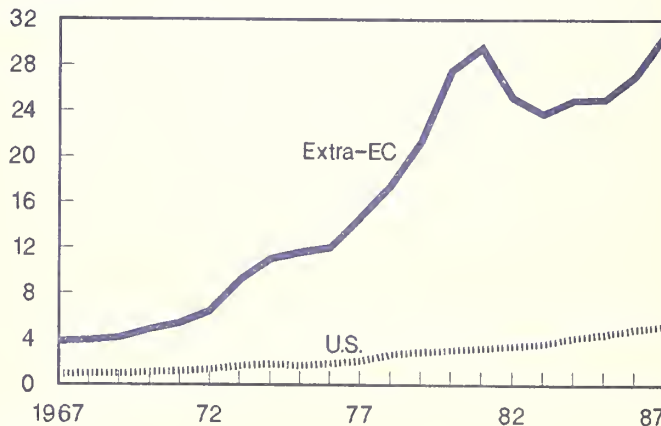


Source: (20).

Figure B-5

EC Agricultural Exports

\$ billion



Source: (20).

National Production Quotas and National Subsidies

Among the gray areas of the 1992 program are: the national production quotas that are used for milk and sugar; and national subsidies or "state aids" that national governments provide to their own farmers. While there are no directives to remove such programs, the national quotas and national subsidies do inhibit competition.

In the case of milk and sugar quotas, the Commission makes a distinction between free intra-EC trade in products and free market determination of the location of production. In the Commission's view, unfettered trade in milk products and sugar is not inconsistent with nontradeable national production quotas. In other words, policies from Brussels will guide production, and the market will guide trade of products among EC countries. National governments have

retained prerogatives over national aids because of remaining tension between the sovereignty of the member states and EC institutions, and because the EC has a great variety of conditions in agriculture and among the general economies of its members.

Milk and Sugar Production Quotas

The EC has instituted various supply control programs for commodities that became expensive to support. By supporting commodity prices well above those prevailing in international markets, the EC encouraged domestic production. When the EC became more than self-sufficient in many commodities, export subsidies were required to dispose of the surpluses. 1/ Quotas have been used since 1968 for sugar and since 1984 for milk (table B-1). The quota systems for milk and sugar, while aiding the objectives of supply control and budget savings, are in direct conflict with the EC objective of a single market, and are, therefore, likely to be modified.

A production quota is an asset. Assets can be bought and sold. It would seem to follow that production quotas should be tradeable throughout the EC. The Dutch dairy board has called for quota trading across national borders (1, Jan. 26, 1990). If the Dutch dairy board is unsuccessful in negotiating with the Dutch Government and the EC Commission for milk quota trading rights, it plans to press for quota trading through the European Court of Justice.

The EC may decide that national quotas are defensible and not contrary to the single market objective. It may decide that a single market is a good concept that should not be carried to extremes. Most farmers are content with the quotas because they get a high price for the quantity allowed under the quota.

Table B-1--EC milk and sugar quotas by country
marketing year 1989/90

	Milk	Sugar (refined)
	1,000 tons	
Belgium/Luxembourg	3,636	826
Denmark	4,525	425
West Germany	21,927	2,602
Greece	540	319
France	24,613	3,802
Ireland	5,300	200
Italy	9,221	1,568
Netherlands	11,213	872
United Kingdom	14,790	1,144
Spain	5,079	1,000
Portugal	1/	70
EC	100,844	12,828

1/ Under its terms of accession to the EC, Portugal retains its national milk program until 1991.

Source: (2).

The alternative to supply control would be price reductions, a course most farmers do not favor. However, national quotas are objectionable on economic grounds because they freeze the historical location of production rather than letting the market allocate production according to comparative advantage. The immediate consequence is that the average cost of producing milk in the Community is higher than it would be without the quotas. A further consequence is that the processing locations for milk and sugar are suboptimal. The governments allocate the national quotas to processors, which tends to freeze production and processing even further.

National Subsidies

National subsidies, or "state aids" as they are officially referred to, have the potential to cushion and hinder the 1992 program. Articles 92-94 of the Treaty of Rome allow the EC to intervene when a member state gives any aid to "distort or threaten to distort" competition among the member states. In the national economies, these subsidies have encompassed many sectors including airlines and auto manufacturers (table B-2). In agriculture, national subsidies cover a variety of measures, including farmers' pensions, implementation of EC policies not funded from Brussels, and subsidies for environmental improvement.

The 1992 program aims to remove national protection measures, and the Commission recognizes that individual member states may be tempted to provide subsidies to give their industries an advantage in the post-1992 EC. For example, national environmental regulations are stricter in some countries than in others, imposing higher production costs in the country with higher standards. Farmers might then seek a compensating payment from the government, claiming that the additional costs of complying with the environmental standards were a result of social, not market, preference and should, therefore, be borne by the government. Otherwise,

Table B-2--National subsidies by country, 1981-1986 average 1/

	National subsidies	Amount for agriculture	
	Billion ECU	Billion ECU	Percent
Italy	27.7	1.862	7
West Germany	19.1	1.402	7
France	16.7	2.870	17
United Kingdom	9.4	1.088	10
Belgium	4.0	.164	4
Netherlands	2.2	.462	21
Ireland	1.1	.259	23
Greece	1.0	-	-
Denmark	0.9	.256	29
Luxembourg	0.2	.022	9
EC	82.3 2/	8.385 3/	-

1/ Includes payments made by national governments to implement EC legislation, reductions in social security contributions, tax benefits, grants, interest subsidies and loan guarantees, research and development grants to firms, state equity participation, and guaranteed payment of net losses; excludes state research expenditures, land drainage, and some regional development funds. 2/ EC-10. 3/ EC-9.

Source: (5).

such additional costs would hurt the competitiveness of farmers in the higher regulating country. If the government agrees to compensate farmers, other countries might claim that the subsidies were too high and either grant countervailing subsidies or seek relief from the EC, claiming unfair competition. The net result is a great deal of uncertainty regarding the impact of the EC 1992 measures.

Plant and Animal Health and Food Safety Harmonization in EC 1992

A third barrier to competition, at present, consists of technical regulations and standards. The elimination of frontier controls will require an enormously complex effort at harmonization in this area. The standards, inspectorates, and testing and certification procedures will guarantee food, plant, and animal health safety on an EC-wide basis after 1992.

There are over 100 EC directives in the 1992 harmonization program that affect plant and animal health, and food safety regulations, and nearly all of them have been proposed by the EC Commission (22). With the exceptions of the hormone ban, the third-country red meat directive, and some potential problems with other directives, the harmonization process does not yet appear to present explicit technical barriers to EC imports.

Internal EC trade is likely to expand because of the methodology the EC is employing. 2/ Internal trade creation will likely have an impact on external trade patterns. Some of the external trade effects could include trade diversion if exporters to the EC are forced out of EC markets because of a more competitive EC.

At this point it appears that any attempt to construct a more protectionist EC through standards will be difficult. This is largely because of the varying level of standards existing within the EC by virtue of diverse climates, national tastes, and fears, reasonable or otherwise, about food safety. Standards set at very high levels may restrict production in some countries. Low standards will be resisted by consumer and environmental groups elsewhere. A compromise will have to be reached to ensure food safety without jeopardizing production in some countries.

Protection of EC markets is more likely to come from testing and certification procedures. The EC's global approach includes conformity assessment and quality assurance components which have yet to be spelled out in detail (23). The issue of acceptance of third-country testing and certification procedures in the EC may prove to be a severe hurdle for imports into the EC.

It is not yet clear how the EC will treat third-country imports. Theoretically, imports should receive the same treatment as goods produced in the EC. In some cases this would give exporters to the EC greater market access if they

could meet the standard. In other instances market access may be lost if exporters could not meet a higher standard. Also, it might prove economical for exporters in some cases to meet higher standards if only one EC standard had to be met instead of 12 national standards.

Elimination of border controls between EC countries and legalization of backhauling for trucks is also expected to lower transport costs significantly in the EC—perhaps as much as 40 percent in some cases (19). EC food companies will thus realize scale economies because of the elimination of borders, lower transport costs, and the harmonization of standards. Lower costs could allow the EC to become more competitive in the world market in processed foods.

The EC 1992-GATT Connection

The outcome for EC imports could well be determined by the GATT negotiations. A GATT agreement in agriculture would go a long way toward ensuring that the EC 1992 harmonization process keeps on track with international concerns. EC acceptance of a proposal in the Uruguay Round to use international scientific bodies to settle sanitary and phytosanitary trade disputes would be a significant step in the right direction (13). Acceptance of the Codex Alimentarius standards for harmonization purposes would be another important next step. Codex standards are set at relatively strict levels which would seem acceptable to the EC, and the EC has stated that it will take the Codex standards into consideration (21).

Conclusions

The EC's 1992 program is attempting to complete the common market in the true economic sense by eliminating all internal barriers to trade. There are no provisions for liberalizing any of the EC's external trade barriers. Any developments here will have to come from success in the current GATT Round, which is scheduled to conclude in December 1990. However, the adjustments to investment, production, consumption and trade patterns within the EC in response to the large number of the 1992 directives will be felt far beyond the EC's borders.

There will be increased opportunities for those able to compete in a deregulated EC economy, especially for companies already doing business in the EC and making changes necessary to respond to a pan-European market. Much of the outcome will depend on the level at which the EC decides to harmonize its standards and regulations. The debate is between the "minimalists," who are pushing for the strictest levels possible, and the "maximalists," who prefer to settle more on the average level that exists around the Community. For companies such as equipment manufacturers who are required to build as many as eight production lines for tractors because of different regulations in EC countries, any har-

monization should be a welcome development. This also bodes well for smaller companies that only do business in one or two EC countries because of the prohibitive costs of establishing multiple production lines.

Eliminating EC customs regulations at internal borders should significantly reduce the cost of transporting goods within the Community. This has important implications for both domestic producers and exporters of food and agricultural products. U.S. gains from EC 1992 will depend on its ability to be competitive in the market.

Problems in achieving a truly common agriculture remain, however. The EC's agrimonetary system is the major impediment. Previous attempts to dismantle it have failed. The prospective reunification of East and West Germany and its implications for the CAP budget will put additional pressure on Brussels to dismantle the system. However, political resistance to cutting producers' support prices and eliminating border taxes and subsidies between member countries will likely prevent any major reform of the system until after 1992.

Meanwhile, with the economic and monetary unification of the two Germanys now planned for next month, countervailing pressures are already being felt for instituting protection of East Germany's relatively inefficient agricultural sector from competition elsewhere in the EC.

It seems likely that when Europeans celebrate their new year in 1993, they will be welcoming many new changes brought about by the 1992 project and a closer realization of the goal of a true common market. Agriculture, however, is likely to maintain some of its special exemptions, and the goal of a genuine common agricultural market will be put off to a future date.

Notes

1/ See the preceding article by Magiera and Johnson on trade-distorting issues in the GATT negotiations.

2/ See the article by Raney and Kelch, below.

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Preferential Trading Arrangements and Agriculture

by
Carol Goodloe and Mary Anne Normile*

Abstract: There is concern that the increasing number and strength of preferential trade arrangements (PTA's) will have adverse effects for the world trading system. Nearly all existing PTA's encountered difficulty when incorporating agricultural products into the initial agreement. The EC has been the most significant PTA affecting total and agricultural trade. Other PTA's have either not had a major effect on trade patterns or have not been in existence long. In the near term, the expansion of PTA's will likely continue.

Keywords: Preferential trade agreements (PTA), GATT, agricultural trade, economic integration, European Community (EC), U.S.-Canada Free Trade Agreement (FTA), Australia-New Zealand Closer Economic Relations (CER), European Free Trade Association (EFTA), Association of Southeast Asian Nations (ASEAN).

Are the world's commercial trading countries moving away from the post-World War II multilateral trading system in the direction of increased bilateral or regional trading blocs? The recently concluded U.S.-Canada Free Trade Agreement (FTA), the greater economic integration now in progress under the European Community's EC 1992 program, and slow progress being made in current multilateral trade negotiations (MTN) have all focused attention on preferential trading arrangements (PTA's), which are increasingly viewed as alternatives to the multilateral system.

The hallmark of modern world commercial trade is a multilateral system, codified under the General Agreement on Tariffs and Trade (GATT). The GATT provides rules for trade behavior of contracting parties, a means for settling trade disputes, and a forum for negotiating further reductions in tariffs and other barriers to trade. The GATT is based on two principles of nondiscrimination: the most-favored-nation principle, and the principle of national treatment. PTA's involve some degree of discrimination in favor of the partners and away from outsiders, and cover a wide spectrum, ranging from consultative and sectoral agreements to full-fledged free trade areas and customs unions.

PTA's can be bilateral or plurilateral, 1/ and can be limited to countries within a region, or include countries in different regions (6). Agriculture may play a large role in these arrangements, or may be completely exempted from preferential treatment. 2/

The Rise of PTA's

Preferential trading arrangements are not new. The protectionist years of the early 1930's were followed by the growth of numerous bilateral, reciprocal trade agreements. Most have since been superseded by the GATT, while others have existed side by side with the GATT since World War II. As countries saw the limitations of the bilateral, reciprocal approach, the GATT was formed to provide a forum for multilateral tariff reductions (2). Since 1948, 69 PTA's have been notified to the GATT under Article XXIV. 3/

Information on some of the larger regional trade agreements is presented in table C-1. These agreements represent over one-third of the world's population and almost two-thirds of the world's gross national product. The level of economic integration, as evidenced by the share of intraregional trade, differs considerably among the arrangements. In addition, other PTA's exist, such as the Lome Convention between the EC and 68 African, Caribbean, and Pacific countries and the U.S.-Caribbean Basin Initiative, that provide developing

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Table C-1--Regional trade agreements 1/

Association	Year formed	Combined population 1988	Combined GNP 1986	Exports, 1987		Regional exports as share of total exports, 1987	
				Total	Agricultural	Total	Agricultural
		Millions	-----	Billion \$U.S.	-----	-----	Percent
Andean Common Market (ANCOM)	1969	88	126	2/ 7.1	2/ 3.0	4	--
Association of Southeast Asian Nations (ASEAN)	1967	321	3/ 214	40.2	6.6	14	14
Australia-New Zealand Closer Economic Relations (CER)	1983	20	212	31.1	13.4	7	3
Caribbean Common Market (CARICOM) 4/	1973	7	10	NA	NA	NA	NA
Central American Common Market (CACM)	1961	26	22	2/ 3.5	2/ 2.6	--	--
Council for Mutual Economic Assistance (CMEA)	1949	477	5/ 1,858	NA	NA	59	5
East African Community (EAC)	1967	64	16	NA	NA	NA	NA
European Community (EC)	1957	325	2,902	950.8	109.1	59	72
European Free Trade Association (EFTA)	1960	32	430	159.7	5.0	15	19
Latin American Integration Association (LAIA) 6/	1960	374	632	2/ 69.6	2/ 21.5	3	2
U.S.-Canada Free Trade Agreement (FTA)	1989	272	4,589	336.6	39.3	38	15

-- = less than one percent.

NA = not available.

1/ Data on population and GNP are the latest available, and include the countries currently in the association.

2/ Data are from 1985.

3/ Data not available for Brunei.

4/ Data not available for St. Kitts and Montserrat.

5/ Data are for 1988 in real 1980 terms and do not include Cuba, Vietnam, and Mongolia.

6/ Formally the Latin American Free Trade Association.

Sources: (8, 17, 18).

countries with preferential access to markets in industrial countries.

The increase in preferential arrangements has raised concerns that their proliferation will have adverse effects for the world trading system. There are both economic and non-economic forces that compel countries to enter into PTA's.

Perceived Weakness of The Multilateral System

By most assessments, the GATT has been instrumental in fostering a favorable climate for international trade since its creation in 1948. But changes in the structure of international trade and the major players have strained the multilateral system and revealed the GATT's shortcomings.

Although past MTN's have been successful in lowering tariffs worldwide, ironically, such successes may be responsible for growth in PTA's. The task of dealing with nontariff barriers (NTB's) and extending GATT disciplines to new areas such as services, agriculture, and intellectual property rights will make it harder to achieve the same success as in the past. The process of multilateral liberalization is constrained by the pace of the least willing member. "... the

speed of the convoy moving toward free trade is limited by the speed of the slowest ship (8, p. 60)."

The slow and complex multilateral process has led frustrated, but like-minded, countries to pursue alternative trade arrangements outside the GATT to achieve greater, more rapid liberalization, such as the 1988 U.S. beef and citrus agreement with Japan and the U.S.-Canada FTA. Over the long run, growth of PTA's may slow the process of trade liberalization if countries perceive greater gains from negotiating bilateral agreements.

The rise of Japan and the newly industrializing economies as economic powers has also placed pressure on the multilateral system. Many industrialized countries have voiced concern that these countries are not playing by the same rules that have governed world trade since World War II. Local business practices, industry structure, and industrial policies have often resulted in informal barriers to trade, which exporters are unable to penetrate despite the absence of formal trade barriers. U.S. frustration with large trade deficits with the East Asian countries has led to increasing use of unilateral

trade legislation, import relief measures, and so-called "gray area" measures to deal with the deficits. 4/

What do the proliferation and strengthening of PTA's imply for the multilateral trading system and the GATT? PTA's are, in many respects, in conflict with the multilateral trading system and GATT principles. As noted, they are discriminatory; they may give rise to trade diversion from former trading partners; they may reduce the momentum for multilateral liberalization; and they create incentives for participants to maintain high external tariffs in order to retain a margin of preference for members (20). A strong PTA, like the EC, may skew bargaining power in multilateral trade negotiations by enabling a number of countries to negotiate as a bloc. PTA's may lead to more PTA's, creating a more fragmented trading system.

On the other hand, PTA's may enhance trade liberalization. A free trade area is viewed as a move toward freer global trade because it results in a greater volume of goods being traded without restriction. Free trade areas, where there is no common external tariff, can also lead to lower tariffs because an importing country has an incentive to unilaterally reduce its external tariff to obtain imports from a lower-cost non-member (21). In the case of a customs union, where there is a common external tariff, the GATT requirement that barriers to third-country trade not be raised means that the external tariff can be no higher than the lowest one of the members. Both processes can lead to an overall lower tariff level.

PTA's may also supplement the multilateral process by deepening concessions already extended to GATT members. PTA's may also extend the benefits of freer trade to areas not covered by the GATT. The GATT has, at least until the ambitious agenda of the Uruguay Round, had little success in addressing nontariff barriers in agriculture. The U.S.-Canada FTA broke new ground in addressing nontariff barriers such as grain import licensing, discriminatory retailing practices, and transport subsidies.

Economic Forces May Push Countries Closer

Economic forces may compel countries to enter into formal preferential arrangements or may result in informal trading blocs as trade becomes more concentrated within a region. One rationale for concluding a PTA is that the expected gains from bilateral or regional liberalization would be greater than from multilateral liberalization.

An example is Canada's desire to conclude a free trade agreement with the United States. With Canada's trade dependence on the U.S. market already high—in 1988, 73 percent of Canada's exports went to, and 66 percent of imports came from, the United States—and a perception of growing U.S. protectionism, Canada concluded there were

greater economic benefits to be gained from a bilateral FTA than from waiting on the uncertain outcome of the MTN (21).

Additionally, a country may be willing to make bilateral concessions that it would never make unilaterally. Canada gained some concessions—for example in the areas of services and dispute settlement—which the United States would not likely concede in a multilateral agreement (21).

Another economic rationale is to improve domestic economic efficiency. The expected gains that would come from unilateral liberalization, as increased competition forces domestic producers to become more efficient, may lead a country to seek a formal agreement to provide the impetus and discipline for liberalization. An example is the Closer Economic Relations (CER) agreement between Australia and New Zealand. The agreement provided the backdrop for recent unilateral liberalization in both countries. This economic motive has also been ascribed to Canada in its pursuit of a U.S. FTA. Many Canadians were concerned that Canada was losing its international competitiveness, and a way to force change was to open the border to the full impact of the more efficient U.S. economy (19).

Other objectives include promotion of intraregional trade, improvement in terms of trade, reduction of current-account deficits, an increase in bargaining power with respect to large countries, and possible achievement of monopoly power (where production is concentrated in a few countries, it is possible to realize monopoly rents through collaboration or collusion).

The process of economic development creates opportunities for increasing trade among countries that previously had little trade. Greater purchasing power, coupled with lower transport costs and similar tastes and culture, are conducive to greater trade links with nearby countries. An example has been the rapid increase in trade between the northeast and southeast Asian countries (3). The increased concentration of trade within a region, which often results in growing trade frictions, may spur countries to pursue more formal trade arrangements (3).

Countries that have lost markets, or think that they may lose markets, as a result of being left out of a formal trade bloc may join with other left-out countries to seek alternative trade opportunities or to create a countervailing economic power. This rationale has been a key element in many countries' trade policies since the formation of the EC in 1957. The European Free Trade Association (EFTA) was created at British initiative when 1950's negotiations for a European free-trade area to include the EC and EFTA countries failed (10, 12).

Japan and Australia also looked to develop closer economic relations with other Asian countries in response to the forma-

tion of the EC (3). Australia and New Zealand's export dependence on the United Kingdom and their subsequent shift to other markets played an important part in the development of the New Zealand-Australia Free Trade Agreement (NAFTA), an early attempt to establish a free trade area (2). Japan and other Asian Pacific countries are exploring increased economic integration as they look across the Pacific at a perceived North American trade bloc and further across the Atlantic at "Fortress Europe" (16).

As countries look at alternatives to the multilateral system, political motivations cannot be underestimated. "The political side is even more important for FTA's than for most other policy issues. After all, it is a political constraint—the actual or perceived inability to achieve the better economic option of multilateral reductions in trade barriers—that provides the justification for the study of the second-best option of FTA's" (21).

Certainly, political and strategic motivations were the main factors underlying the formation of the Council for Mutual Economic Assistance (CMEA or COMECON) by the USSR and the Eastern European countries after World War II. According to one author, the United States' overriding objectives in signing a free trade agreement with Israel were political (15). Countries may enter into PTA's as part of a strategy to signal their intentions to seek alternatives to the multilateral system, a U.S. motive underlying the agreements with both Israel and Canada (15).

Agriculture in PTA's

Nearly all existing PTA's encountered difficulty in incorporating agricultural products into the initial agreement. Agriculture has proven difficult to liberalize within PTA's for the same reasons that it has proved to be a sticking point in the GATT. 5/ Farm support operations frequently require that import barriers be maintained to protect domestic producers from low-cost imports. These policies tend to be maintained in the early years of most agreements.

In most PTA's, the agricultural sector has usually benefited less from across-the-board reductions in tariffs or nontariff barriers. In some cases, agricultural products are excluded from trade concessions altogether. Agriculture is easily excluded from PTA's because most agreements can fulfill the requirement of GATT Article XXIV that "substantially all trade" be included without significant liberalization of agricultural trade. Other arrangements are moving toward full liberalization of agricultural trade between members. (See box for details on major PTA's.)

The Treaty of Rome, which established the EC, provided for separate treatment for agriculture. The Common Agricultural Policy (CAP) largely integrates the agricultural sector, yet agricultural trade is less free than trade in industrial goods. Despite the CAP's objective of free flow of agricul-

tural commodities within the Community through common pricing, such pricing does not exist for many agricultural commodities, and barriers to agricultural trade within the EC persist. 6/ The CAP has also had a significant effect on agricultural production and trade outside the EC in that surplus production resulting from high support prices must be disposed of with the aid of export subsidies. Subsidized exports displace exports of low-cost producers and depress world market prices (10).

In contrast, agriculture was specifically excluded from the agreement that established EFTA, and agriculture continues to be insulated from market forces in EFTA countries. Bilateral free trade agreements between individual EFTA member countries and the EC cover a few agricultural products. EFTA countries import more agricultural products from the EC than they do from other EFTA countries (17).

The agricultural provisions in the U.S.-Canada FTA were not comprehensive, except for tariff reduction, and left each country's agricultural policies basically intact. In the U.S.-Israel FTA, agricultural products were accorded special treatment. Tariff reduction for certain "sensitive" agricultural products likely to compete with U.S. products was deferred until the 10-year target completion date (1).

Under the 1983 Australia-New Zealand CER agreement, agriculture in general received special treatment, with many products being exempted from liberalization or subject to special conditions. However, under the 1988 revised agreement, there will be substantially free trade in agricultural products as of July 1990. For the Association of Southeast Asian (ASEAN) countries, treatment of agriculture is limited mainly to cooperation in the fields of animal health, research, and technology. The Lome Convention countries constitute a rather special arrangement in their relations with the EC in that their exports are heavily agricultural—coffee, cocoa, tea, bananas, and sugar especially.

PTA's and Changing Trade Patterns

PTA's can be assessed according to whether they stimulate internal trade relative to external trade. An increase in internal trade *per se* is not necessarily an indicator of the economic success of a PTA, but it does indicate how powerful the effects of the PTA have been (21). These effects can be good or bad from an economic efficiency point of view.

An assessment of a PTA's effects on trade is complicated by many factors, including the diverse nature and objectives of the agreements and the different periods for which they have been in force. For example, ASEAN was not originally intended to pursue economic integration, so it would not be surprising to find that intraregional trade had not prospered. The Treaty of Rome's goals of encouraging the free flow of goods within the Community, and giving priority to EC goods, would be expected to produce large gains in

intraregional trade at the expense of trade with third countries.

A formal PTA may grow out of an already highly concentrated trade relationship, such as Canada's with the United States. In this case, a formal trade agreement may have limited effects on intratrade because many of the opportunities have already been exploited.

One assessment of a PTA's effects on trade patterns concluded that the Central American Common Market (CACM), EC, EFTA, and the Andean Group (ANCOM) increased internal trade, while ASEAN, NAFTA, the Latin American Free Trade Area (LAFTA), and the East African Community (EAC) had no obvious effect on internal trade. Key factors explaining the differences in performance included the comprehensiveness of product coverage, similarity of economic structure, and the size of the association. Geographical proximity was not always a significant factor (21).

Two general indicators are presented for the period 1962-87—intraregional exports as a share of total exports (trade concentration), and growth in intraexports relative to growth in total exports (intragrowth)—to examine growing trade concentration and to assess the effects of several PTA's. These indicators cannot prove whether an increase in trade concentration was the result of a PTA, but (as suggested by Wonnacott above) can indicate how powerful the agreement has been in stimulating intraregional trade.

For the EC, concentration for both total and agricultural trade was already high in 1962 and has steadily increased (table C-2). Intraexports have grown faster than total EC

exports, and faster than world exports (table C-3). The formation and further integration of Western Europe, by stimulating internal trade relative to external trade, forced traditional trading partners to look elsewhere as they were closed out.

The CAP has had a particularly significant role in world agricultural trade. By encouraging domestic production through high agricultural support prices and protection from cheaper imports, the CAP has resulted in increased agricultural trade within the EC at the expense of imports from non-EC countries. Canada, Australia, and New Zealand were traditional suppliers to Europe, especially the United Kingdom. Their shares of the EC agricultural market declined since the early 1960's as the EC developed and enlarged, as shown by United Nations trade data (fig. C-1).

The U.S. share, while more erratic, declined from 1962 to 1987, falling off sharply since 1980. The 4 countries' combined share of EC imports fell from 25 percent in 1962 to 10 percent in 1987. Over the same period, trade in agricultural products among EC countries rose from 27 percent to 63 percent.

Loss of the EC market forced former suppliers to seek export outlets elsewhere. The share of Canadian agricultural exports going to the EC fell from about 50 percent in 1960 to just 10 percent in 1987. A similar story can be told for Australia and New Zealand (fig. C-2). Although the trade-distorting aspects of the CAP do not explain all the change in trade patterns for these countries—growing import demand in Japan and large imports by the USSR and China in the 1980's were also significant factors—the CAP had a major effect on these three countries' agricultural export patterns.

Table C-2--Trade concentration: Intra-regional exports as a share of total exports

Region	1962	1965	1970	1975	1980	1985	1986	1987
Percent								
EC 1/ Total	46	50	53	53	57	55	57	59
Agricultural	60	63	66	70	66	66	70	72
EFTA 1/ Total	25	27	31	19	14	17	18	15
Agricultural	28	29	29	20	18	16	18	19
ASEAN Total	16	12	15	14	20	17	14	14
Agricultural	13	13	17	14	20	17	14	14
Australia-New Zealand Total	NA	6	6	6	6	6	6	7
Agricultural	NA	1	1	1	2	2	3	3
U.S.-Canada Total	2/ 26	29	33	31	26	38	37	38
Agricultural	2/ 11	11	13	9	8	13	15	15
East Asia Total	10	10	13	12	13	13	14	16
Agricultural	26	35	46	44	45	52	57	63

1/ Data includes only member countries at that time.

2/ 1963.

Source: Derived from (17).

Table C-3--Growth in total and intra-regional trade for major PTA's and regional trade blocs 1/

Group	1962-71	1972-81	1982-87
Percent			
European Community			
Exports to world	10.6	18.4	7.7
Exports to region	12.3	18.4	9.1
Agricultural exports to world	9.1	18.5	7.0
Agricultural exports to region	10.4	17.7	8.6
European Free Trade Association			
Exports to world	8.7	9.6	7.5
Exports to region	2.8	1.1	7.7
Agricultural exports to world	6.7	1.4	3.1
Agricultural exports to region	6.8	-4.4	4.0
U.S.-Canada 2/			
Exports to world	8.6	15.7	3.2
Exports to region	12.8	12.8	7.5
Agricultural exports to world	4.1	16.3	-2.8
Agricultural exports to region	5.0	11.5	4.7
New Zealand-Australia 3/			
Exports to world	5.4	13.0	2.9
Exports to region	6.1	14.6	5.2
Agricultural exports to world	1.0	10.0	2.1
Agricultural exports to region	2.4	13.6	11.5
Assoc. of Southeast Asian Nations			
Exports to world	5.5	27.8	-5.5
Exports to region	4.8	29.9	-6.0
Agricultural exports to world	2.4	17.3	-6.2
Agricultural exports to region	4.7	18.2	-8.6
East Asia 4/			
Exports to world	17.7	23.0	7.4
Exports to region	19.5	22.2	11.7
Agricultural exports to world	9.2	10.3	13.5
Agricultural exports to region	14.7	9.4	20.0
World exports			
Total exports	9.6	17.0	5.3
Agricultural exports	5.4	13.6	2.8

1/ Average annual growth rate.

2/ 1963-71.

3/ 1964-71.

4/ Japan, South Korea, Taiwan, and Hong Kong.

Sources: (8, 17).

EFTA was created as a counterweight to the EC, but was not designed to become a customs union. It is hard to draw conclusions about EFTA's impact on intratrade because of the changing country composition (see box). Trade concentration has not increased. For most periods, intraregional trade has not grown as fast as total trade. Although trade concentration data suggests that intraregional agricultural trade is more concentrated than total trade, the actual volume of trade in agricultural goods, both with EFTA and with other countries, is very low.

More important has been growth in EC-EFTA trade. EFTA countries import more from the EC (about \$100 billion in 1987) than they import from other EFTA countries (\$23 billion). EC-EFTA combined trade (exports plus imports) amounts to about \$200 billion, making this free-trade area the largest in the world.

For Australia and New Zealand, trade concentration has been very low and has increased for agricultural trade only in the 1980's. Although the NAFTA, in effect between 1965 and 1984, was not considered effective in stimulating intraregional trade, growth in intratrade has generally exceeded growth in total trade. This was especially so in 1982-87, which roughly corresponds to the tenure of the CER.

The story for ASEAN is mixed. For total trade, concentration has been low with no apparent trend. For agricultural trade, there has been a general, if erratic, increase in intraexports relative to total exports. Intraregional exports generally grew faster than total exports in the 1960's and 1970's, yet fell faster in the 1980's. On paper, ASEAN is moving toward regional integration, but has made only limited progress so far.

Figure C-1
Share of EC Agricultural Imports

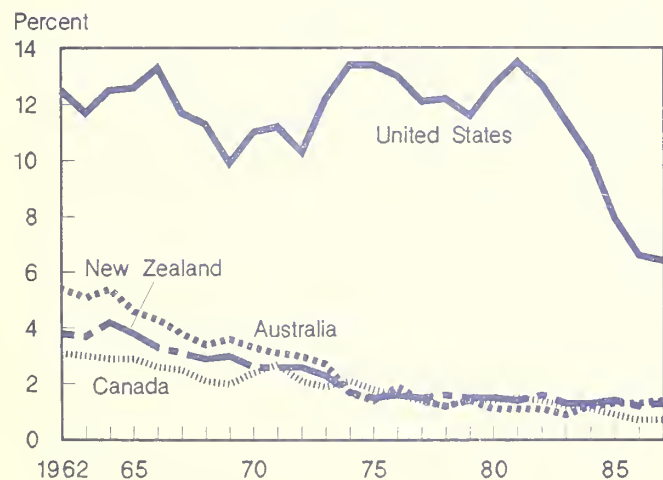
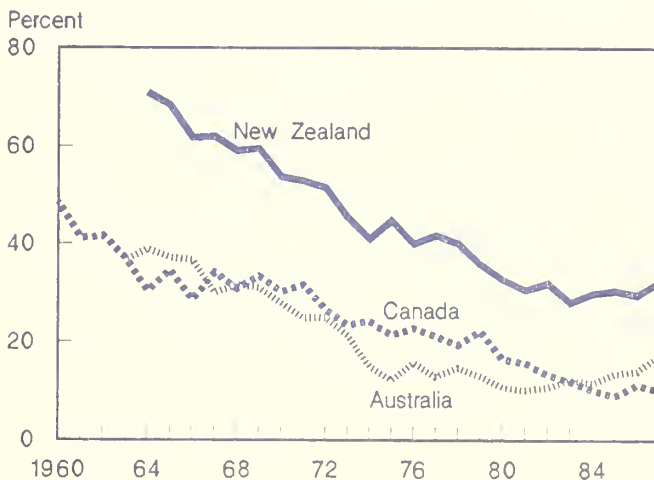


Figure C-2
Share of Agricultural Exports to EC



The U.S.-Canada FTA has only been in effect since January 1, 1989, so it is not yet possible to assess its effects on trade. Nevertheless, the data confirm the notion that as intratrade became more concentrated, Canada sought out formal confirmation of its bilateral trade relationship. Trade concentration data show two cycles. Concentration rose until the early 1970's, then fell until 1980, when it rose again. Intragrowth tells a similar story; intraexports grew faster than total exports in 1963-71, slower in 1972-81, and then exceeded total export growth again in 1982-87.

Although there are no formal trade arrangements among the East Asian countries, trade concentration has increased. Agricultural exports, although less significant than total exports, because these countries are large importers from without the region, have also become more concentrated. Intragrowth was largest for the 1982-87 period. The growing concentration among the East Asian countries, plus increasing U.S.-East Asian trade and Japan-ASEAN trade, make the Pacific Rim area a ripe spot for talk about forming PTA's (3, 4).

Outlook for PTA's

In the near term, the expansion of PTA's will likely continue. Forces already in motion will lead to greater integration among existing PTA's, will expand some PTA's to include more countries, and may formalize ties among regional trading blocs with new agreements.

Recent developments in Europe point to accelerating economic integration among the countries and between existing trading blocs. The EC will become more integrated as the 1992 process advances; closer economic ties and trade links between the EC and EFTA are being forged with the goal of creating a "European Economic Space;" the 12-member EC could expand further as other European countries seek membership; German unification would mean the eventual economic integration of East Germany, long considered the "13th member," into the Community. Greater market orientation among some Eastern European countries should lead to increased trade with the market economies of Western Europe.

The weakening and possible dissolution of CMEA may provide these countries with a further incentive for closer trade ties with—and possibly membership in—the EC. The EC has had an economic cooperation agreement with Yugoslavia since 1980, and is considering special agreements to expand trade with Poland, Czechoslovakia, and Hungary (11).

A long-discussed idea of a North American free trade area among the United States, Canada, and Mexico may be moving closer to reality. In late 1987, the United States and Mexico signed a framework agreement designed to improve bilateral trade relations. Canada signed a similar agreement with Mexico in March 1990. The United States and Mexico recently began preliminary discussions on establishing a free trade area.

In the Pacific Rim, the idea of economic cooperation has been around since the 1960's. Growing trade concentration and accompanying friction between East Asia and its trading partners, the possible trade-diverting effects of the FTA, and the EC 1992 process in Europe all lend renewed urgency to regional economic cooperation in the Pacific (3). There have been a variety of U.S. proposals for more formal economic arrangements with Pacific Rim countries, including free trade agreements with Japan, South Korea, Taiwan, and ASEAN. Last fall, Australia hosted a meeting of 11 Asian Pacific countries, including the United States, to advance the process. The group will meet again as the Asia-Pacific Economic Cooperation Council (APEC).

What is the outlook for the world trading environment—a tighter, more comprehensive GATT system or an even more fragmented, managed trade system characterized by PTA's?

Much depends on the outcome of the Uruguay Round, where resolution of agricultural issues is key. If the most contentious issues can be resolved in a satisfactory manner that results in a strengthened GATT system, some of the impetus to forge PTA's will be removed. A failed GATT Round suggests the opposite course will be followed. A third possible outcome is a continuation of the current situation, where a kind of dual trading system exists in which countries rely both on the GATT and on bilateral or plurilateral trade agreements to achieve their trade objectives.

The United States, as a major agricultural trader, will play a crucial role in any of these three outcomes. The multilateral trading system has prospered under U.S. leadership. Continued U.S. support for the GATT will be even more important if countries resort increasingly to bilateral or plurilateral arrangements.

If the Uruguay Round fails to produce a satisfactory agreement, agriculture will remain uncovered by many provisions of the GATT. In this case, the proliferation of PTA's, with their mixed record in liberalizing agricultural trade when looked at in a worldwide perspective, could reduce the likelihood of achieving a more liberal trading regime in agricultural products.

PTA's are usually categorized according to the extent of economic integration provided by the agreement.

- **Limited or partial preferential agreements** extend to a country, or group of countries, trading terms more favorable than the most-favored-nation status and are non-comprehensive in product coverage. Trade concessions may be extended unilaterally.
- **Free trade areas** are characterized by free trade in all or most goods between members. Each country may maintain independent trade policies, including tariffs, with respect to trade with non-members.

- **Customs unions** involve free trade in goods among members as well as a common external tariff (or other trade policy) on trade with non-members.
- In a **common market**, there is free movement of capital, labor, and services, as well as goods, between members.
- An **economic and monetary union** is characterized by common economic policies and a single currency between politically independent countries.

PREFERENTIAL TRADING ARRANGEMENTS

EUROPEAN COMMUNITY (EC)

- **Type and date of agreement**—The Treaty of Rome (1957) established the European Economic Community with the goal of forming a common market. The EC in 1990 most closely approximates a customs union.
- **Countries involved**—From the original six—Belgium, France, Italy, Luxembourg, Netherlands, and West Germany—the EC has been enlarged through accessions of Denmark, Ireland, and the United Kingdom in 1973, of Greece in 1981, and of Portugal and Spain in 1986.
- **General features**—A customs union exists for trade in industrial goods—tariffs and quantitative restrictions have been eliminated on trade among members and a common external tariff applies to imports from third countries. Barriers still exist to the free movement of persons, services, and capital. The EC Commission is a supranational entity empowered to determine commercial policy and negotiate in matters dealing with trade on behalf of the member states, subject to the approval of the councils of ministers of member states, and the European Parliament.
- **Treatment of agriculture**—Agriculture is one of only two sectors where a “common policy” was established. The Common Agricultural Policy (CAP) provides a uniform system of market organization and, in principle, common pricing to allow a free flow of agricultural products within the Community, while import barriers maintain preference for EC products.

EUROPEAN FREE TRADE ASSOCIATION (EFTA)

- **Type and date of agreement**—Free trade agreement, established in 1960.
- **Countries involved**—Currently Austria, Finland, Iceland, Norway, Sweden, Switzerland (and, formerly, Denmark, Portugal, and the United Kingdom before their respective accessions to the EC).
- **General features**—The free trade area was founded to promote prosperity by eliminating barriers to nonagricultural trade. Tariffs and quotas have been removed on all products except farm products and fishery products. Each country retains autonomy in trade policies toward non-member countries. The agreement operates by consensus of members in the EFTA Council.
- **Treatment of agriculture**—Trade in agricultural goods is specifically omitted from the free trade provisions. A number of goods manufactured from agricultural products are traded duty-free.

CLOSER ECONOMIC RELATIONS (CER)

- **Type and date of agreement**—Free trade agreement, effective 1983.
- **Countries involved**—Australia and New Zealand.

- **General features**—The CER replaced the less comprehensive New Zealand-Australian Free Trade Agreement of 1965 (NAFTA). Under the CER, all tariffs on bilateral trade were to be removed by 1988, and all import licenses and quotas by 1995. Export incentives and subsidies were to be eliminated by 1987. In a 1988 review, the timetable for removing barriers was accelerated and the Agreement was broadened. Both countries agreed to remove virtually all impediments to achieving bilateral free trade by July 1, 1990.
- **Treatment of agriculture**—Under the 1983 Agreement, many agricultural products were subject to special arrangements or exemptions, including wheat, sugar, dairy products, tobacco, and some fruits and vegetable products. Under the 1988 Agreement, there will be substantially free trade in agricultural products, including such sensitive areas as dairy products and harmonization of technical regulations (3, 9).

U.S.-CANADA FREE TRADE AGREEMENT (FTA)

- **Type and date of agreement**—Free trade agreement, effective January 1, 1989.
- **Countries involved**—United States and Canada.
- **General features**—All tariffs are to be phased out over 10 years. The FTA removes other trade barriers on a wide range of goods and services, including energy, services, automobile trade, government procurement, business and financial services, and investment. New dispute settlement provisions are also included.
- **Treatment of agriculture**—All agricultural tariffs are to be phased out over 10 years, with some to be phased out sooner. For the next 20 years, fresh fruits and vegetables are eligible for a temporary duty if certain price and acreage conditions are met. Other provisions liberalize quantitative restrictions affecting trade in sugar, poultry products, some grains, and red meat. Canada will remove discriminatory pricing and distribution requirements on wine. Additional provisions aim at harmonizing technical regulations affecting agricultural trade.

U.S.-ISRAEL FREE TRADE AGREEMENT

- **Type and date of agreement**—Free trade agreement, effective August 19, 1985.

- **Countries involved**—United States and Israel.

- **General features**—Tariffs on all products are to be eliminated within 10 years, in 4 stages, depending upon whether the product is classified as sensitive or non-sensitive. Israel agreed to liberalize licensing procedures, to eliminate export subsidies, and to sign the GATT subsidies code. There is a non-binding commitment to liberalize trade in services, which may later become binding.
- **Treatment of agriculture**—Both countries' agricultural policies remained intact. Many agricultural products are classified as sensitive and thus subject to slower rates of tariff reduction. The U.S. established a fast-track emergency safeguard procedure to protect against a possible surge in injurious imports resulting from tariff reduction (1).

ASSOCIATION OF SOUTHEAST ASIAN NATIONS

(ASEAN)

- **Type and date of agreement**—General agreement to promote regional cooperation in economic, social, and cultural fields; effective 1967.
- **Countries involved**—Indonesia, Malaysia, Philippines, Singapore, Thailand, and, since 1984, Brunei.
- **General provisions**—The Agreement was not originally intended to pursue eventual economic or political integration. However, a number of programs have been implemented to improve regional economic cooperation. The 1977 Agreement on Preferential Trading Arrangements began a program of tariff reduction. Other schemes have been implemented in the 1980's to lower tariff and other barriers to promote cooperation on joint projects. There are agreements that promote limited cooperation in the areas of energy, finance, banking, customs procedures, insurance, and taxation (7).
- **Treatment of agriculture**—Some agricultural products have received preferential treatment under the schemes described above. A food reserve scheme, primarily for rice, was set up in 1979 to help meet temporary food shortages. Under the ASEAN Common Agricultural Policy, there is limited cooperation in the areas of plant and animal health regulations, research, and technology exchange.

Notes

1/ We will follow convention in using plurilateral to refer to groups smaller than the membership of the GATT and multilateral to refer to the full GATT membership (2).

2/ The preferential trade arrangements discussed in this article are distinguished from the extremes of limited, consultative agreements and multilateral trade agreements in that they are comprehensive, involving concessions relating to a large number of commodities or sectors; are discriminatory, limiting the benefits of concessions to a small number of countries; and, since the institution of the GATT, are preferential, generally offering terms more favorable than the most-favored-nation treatment accorded to GATT contracting parties.

3/ Under GATT Article XXIV, free trade agreements are allowed if they meet 3 tests: detailed notification is given to all GATT signatories; the agreement applies to substantially all trade; and the agreement does not raise barriers to third-country trade.

4/ Gray area measures include voluntary export restraints, orderly marketing arrangements, and intraindustry agreements. The GATT Secretariat has documented over 200 such arrangements currently imposed by member countries (15).

5/ See article by Magiera and Johnson, above.

6/ See article by Gardiner, Neff, and Kelch, above.

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International Commodity Agreements: The Scattered Remains of Planned Markets

by

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Abstract: Ten years ago international commodity agreements were attempting to control prices in most major tropical agricultural markets and an increasing number of temperate agricultural markets. Most of these agreements failed to implement the control they sought, and now few agreements even attempt price control. Rubber and cotton remain controlled, in part, while a less ambitious role for international commodity agreements has been accepted in other markets.

Keywords: International commodity agreements, agricultural trade.

Exporting nations have frequently put aside their competitive inclinations in order to promote their mutual interests. If exporters cooperate to reduce the quantities of a product on the international market, the price of that commodity will be higher than without collusion, other things being equal. With an effective level of output constraint, all the exporters are better off than they would have been in an open market.

This principle underlay the formation of the Organization of Petroleum Exporting Countries as well as numerous agreements among countries covering individual agricultural commodities. At least 13 agricultural markets (in addition to those of petroleum, bauxite, tin, diamonds, copper, iron ore, tungsten, and mercury) have been targeted by international commodity agreements (ICA's).

Several mechanisms are used to influence international price, most of which rely on trade restraint by exporting nations. For example, direct export quotas allocated among the exporting signatories have been used in the International Sugar Agreement. More commonly, however, international agreements establish a buffer stock made up of members' contributions. Such stocks can be used to offset weather-induced price fluctuations, as the cocoa and rubber agreements attempt to do. Alternatively, exporters have sometimes negotiated purchase contract prices with different prices for members than for non-members, as in the coffee market.

ICA's evoke economic and political forces that tend to limit their effectiveness. 1/ Exporters can make even greater profits by trading larger quantities than the ICA permits. Importers who suffer from higher prices may use their market power in other commodities to retaliate against members of the ICA. Intergovernmental agreements generally have difficulty in organizing markets dominated by private multinational traders. Despite efforts to adapt ICA's to these

pressures, the number that effectively control price or quantity in international markets today is relatively small.

The potential conflict between importers and exporters has been, at least temporarily, resolved within some ICA's by including both groups in the agreement. Importers might benefit from improved information and price stability, despite higher average prices, or they might dominate the agreement sufficiently to lower prices below open market levels. The most frequent justification for importer participation, however, has been to assist in the economic development of exporting countries. For this reason, most of the agricultural ICA's have covered tropical products that are mainly exported by developing countries.

Recent changes in the role played by ICA's have generally been initiated by importing countries, particularly the United States. The changes express a U.S. preference for increased reliance on the open market, although the rationale for specific changes varies among ICA's.

Most of the agreements in temperate commodities (or commodities competing with temperate agricultural products), have failed to control the market because the major exporters, including the United States, have relied on domestic policies to achieve their goals. The tropical product agreements have exerted little market control because their organizations have been underfunded in relation to their ambitions, particularly when confronted by resistance from importers. The major exception to this pattern is the Multifiber Arrangement, which remains strong despite recent reconsideration of its role.

The funding problem was addressed by a proposal in 1976 by the United Nations Conference on Trade and Development to establish a Common Fund for Commodities. The Fund proposal was adopted four years later, but it did not enter into effect until mid-1989, when the minimum number of countries had ratified it. The Fund operates as an independent organization, which the United States has not joined.

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During the decade's delay between the adoption and actually taking effect, the Fund shifted its focus. Originally it was primarily intended to assist in funding ICA buffer stocks to stabilize prices. Only the rubber ICA qualifies for this service today. Its dominant function is now funding commodity development projects such as research on improving productivity or marketing.

Temperate-Competing Commodities

Developing country interests provide much of the justification for ICA's covering temperate-competing commodities. The grain agreement focuses on import needs. The sugar agreement protects specific developing-country exporters of cane sugar, who are faced with subsidized beet sugar production by the United States and the European Community (EC). The agreement on olive oil provides minimal coordination of a submarket of the vegetable oil market which includes products from a number of countries. Only in dairy products is there an ICA with few development concerns.

The most recent International Wheat Agreement was signed in 1986 and will continue in force until July 1991. It follows a series of similar agreements that began in 1933. The 1933 Agreement attempted to control international prices and set quotas to reduce production by its members. Only one country complied with its production quota and a new system was adopted in a smaller Agreement signed in 1944. That agreement and its subsequent versions failed in their attempts to influence prices, and the proportion of international trade originating in member countries fell steadily to only 25 percent by 1956. Finally, in the 1971 version, price control was eliminated from the objectives.

The current agreement fits the characterization of temperate product commodity agreements as primarily an information service for the market and makes no attempt to influence prices or production. It is separated into two legal instruments, the Wheat Trade Convention and the Food Aid Convention. The Wheat Trade Convention collects data and provides a forum for discussion of international grain trade issues. Despite its name, the Convention covers barley, corn, sorghum, and rice in addition to wheat. The Food Aid Convention coordinates commitments by its donor members for specific amounts of food aid in order to assure that acceptable global minimums are planned and met. Donors, as a group, typically surpass their planned contributions.

International control of sugar trade has been pursued by the International Sugar Organization since it first produced an agreement among European sugar producers and consumers in 1864. The modern history begins with the Sugar Convention of 1902 that was the first ICA to ascribe policy authority to an international committee. The agreement did not effectively survive World War I, but a similar agreement in 1931 attempted to restrict stocks and exports. This agreement, however, had little impact on either goal as production by

non-members greatly increased by 1935. The 1937 agreement controlled production but was unable to raise prices until the 1950's, when production quantities responded to higher prices and the agreement collapsed. The 1954 agreement appeared relatively successful, and it expanded the proportion of the market covered, but shortly after renegotiating it in 1959, it collapsed again as the United States reallocated quota away from Cuba. Subsequent agreements had limited success in price control, constrained significantly by the absence of European Community (EC) participation. Since 1971, the agreements have included only data gathering and other administrative functions.

The Dairy Arrangement, signed in 1979, attempts to maintain a minimum international price while stabilizing and expanding trade. It seeks some form of market liberalization despite this export price control. A sale of butter by the EC at low prices to the USSR in 1984 led to a crisis in the Agreement that resulted in withdrawal by the United States and Austria.

Tropical Commodities

Tropical ICA's include the commodities developing countries depend upon most for export revenue. Coffee, bananas, and rubber each provide more than half the export revenue of several countries (1). The only other agricultural export as important to developing countries is cotton, which is effectively controlled through operation of the Multifiber Arrangement.

ICA's covering tropical products have been more successful than those for temperate products in controlling their markets, although few now actively intervene to affect price. Agreements covering rubber, coffee, jute, tea, pepper, and hard fibers can claim some control of markets, in addition to filling information and market development functions. Agreements for bananas, cocoa, and tropical woods have only performed informational roles.

The first International Rubber Agreement (INRA) was signed in 1979. The second agreement beginning in 1989 also includes all major importers (including the United States) and most major exporters (lacking only Liberia). The organization maintains a buffer stock from member contributions and adjusts its stocks to stabilize international prices at levels determined by the members. Recently, the organization's stocks were depleted in an effort to hold down prices, but stock adjustments have generally served well enough to retain member support for the organization.

The International Coffee Organization (ICO), intermittently regulating the international coffee trade since 1962, partially collapsed in 1989. The ICO price-regulating functions, in force since 1983, were terminated at a special ICO Council meeting on July 3, 1989, and the ICO was extended as an administrative pact for 2 years, starting September 30, 1989.

The change resulted from disagreement between the member country exporters and importers on coffee sold to nonmembers being re-sold to members at higher prices, and the range of coffee grades made available under the agreement. Disagreement also developed among producers because export quotas were allocated according to historical levels, disregarding importers' demand (2).

The immediate effect of these changes in the coffee agreement was a drop in international coffee prices, which plunged 60 percent in July 1989 and reached a 14-year low by October 1989. Member producing countries with sizeable stocks took advantage of the quotas' demise to sell their surpluses. A small price recovery occurred after stocks in producer nations were reduced. The recovery is expected to continue due to poor coffee crops in Central and South America, but there is not yet any sign that the market will bear prices near levels prevalent during the stronger version of the Agreement.

Intervention in jute trade was initially successful through the Intergovernmental Group on Jute, Kenaf, and Allied Fibers, formed in 1965. The group set prices to be charged by exporters who complied relatively well until 1974, when no agreement on the proper level was reached and Bangladesh raised its prices 8 times. The group continues today, but it attempts no direct influence on prices.

The International Agreement on Tea was active from its signing by major exporters in 1933 until World War II. It raised prices and limited their variation through export quotas. The agreement expired in 1955, after several years of establishing quotas too high to have any effect. In 1969, the Intergovernmental Group on Tea was formed through the Food and Agriculture Organization (FAO) of the United Nations. Its Subgroup of Exporters attempted to establish informal export quotas, but the agreed-upon levels were also too high to constrain trade. The tea market is now serviced by the International Tea Committee whose main function is data collection.

As occurred with tea, the hard fibers market was organized through the FAO. In 1966, the Intergovernmental Group on Hard Fibers was formed covering sisal, henequen, abaca, and coir. As with tea, informal export quotas were established to achieve price levels accepted by both importers and exporters. Although prices were stabilized, the quotas did not raise prices as planned, and intermittent efforts to set effective quotas were eventually abandoned.

The Association of Banana Exporting Countries (UPEB) was formed in 1974 by Colombia and four Central American countries to establish pricing and other marketing policies, including export taxes. Opposition from private multinational corporations prevented the association from having much effect and it was followed, in 1975, by the Intergovern-

mental Group on Bananas (IGB), consisting of both exporters from around the globe and importers including the United States. This group experienced a fate similar to its predecessor. Today the International Banana Association, headquartered in the United States, services all major producers with data collection and advertising.

The International Cocoa Organization (ICCO) was formed in 1972 with the principal purpose of influencing prices through adjustments in buffer stocks. Neither that agreement nor its successor, in 1975, was tested for its ability to affect price because the price of beans rose steadily during the 1970's without intervention. The agreement that took effect in 1981, however, removed 100,000 tons from the market in an unsuccessful attempt to hold up prices in its first year. Despite the ICCO's ability to extract levies from nonmembers, the failure of the largest exporter (Ivory Coast) and the largest importer (United States) to participate greatly weakened the organization. Furthermore, the ICCO levy on cocoa was too small to finance the necessary purchases to achieve its goals.

In 1990, the agreement was extended for 2 years without economic provisions. The 250,000-ton stock level was to be maintained, levies on producers were to be ended, and stock maintenance was to be financed by sales from the stock itself. The United States refuses to sign the current agreement, and the ICCO remains unable to regulate prices. By 1990, the cocoa market was in its seventh consecutive year of surplus production, so producing nations show little interest in holding back sales for price support purposes. That goal is made harder to achieve by inelastic demand for cocoa that indicates any price control will require broad participation.

The first ICA on wood was formed in 1985. The International Tropical Timber Organization (ITTO) accepted lessons from earlier ICA's and set its goals modestly with an emphasis on research and coordination of private corporations. The International Pepper Community sets minimum prices, but world market levels have consistently been higher than these.

Multifiber Arrangement

Under a special exception to GATT rules, called the Multifiber Arrangement (MFA), the developed countries have had the legal right to restrict their imports of apparel and textiles from developing countries. Within the guidelines of the MFA, trade in items made from cotton, wool and certain other fibers is governed by a set of bilateral quotas which serve to protect the developed-country producers. Importers have complete discretion in choosing the countries and commodities covered by these bilateral pacts. The first MFA was signed in 1974. There have since been three renewals, with the most recent covering 1986-91.

The stated purpose of the first MFA was the orderly accommodation by the developed country producers of emerging comparative advantage of production in developing countries. The MFA was to provide a transition period for developed-country producers to reduce their scale before the market returned to unrestricted trade. The long-term goal of open trade was initially served by providing for quota growth of 6 percent annually, a rate higher than the growth of developed-country consumption, which implied an increasing share for imports. Flexibility to weaken the quotas was further enhanced by provisions allowing the transfer of quotas across commodity categories, to carry over unused quotas into subsequent years, and to borrow against future years' quotas.

Despite the apparent original intent, the MFA has become progressively more restrictive. Annual growth rates of goods under quota have generally been well below the specified 6-percent minimum, more product categories have been placed under control, very small suppliers have been put under quota, minimal evidence on market distortion has been offered to justify expanded quotas, and new mechanisms have been introduced to automatically trigger tighter quotas within bilateral agreements.

The latest MFA (which was signed by 54 countries) broadened coverage of controlled textiles to encompass silk, linen, and ramie, while extending the term of the MFA from 4 to 5 years. It also provided greater scope for industrial countries to tighten quotas through "antisurge" formulas and "reasonable departure" clauses.

As a consequence of the MFA, the protection afforded to U.S. fiber production, textiles, and apparel is probably greater than any other industry. In addition to relatively high tariff rates (averaging about 20 percent), the United States has over 1,500 quotas in place on more than 140 product categories with 40 countries. About 75 percent of 1988 textile and apparel imports were subject to quotas. The bilateral MFA agreements with the four largest suppliers provided for an annual growth rate ranging from 1 to just over 3 percent.

The future of the MFA may bring a return to the original liberalization mandate. Talks on the MFA are proceeding as part of the current negotiation under the GATT. The opening declaration, signed in Punta del Este, Uruguay, in 1986, promised "substantial negotiations will begin within the time-frame of the Uruguay Round on modalities for integration of this sector into GATT." This language came at the insistence of developing countries, led by India and Brazil, who regard the MFA as a key component of the GATT talks.

The GATT midterm agreement of April 1989 established that industrial countries would discuss a mechanism for dissolution of the MFA. A transition period of about 10 years is generally accepted as necessary to accomplish the integration of this sector into the GATT. The format for liberaliza-

tion, however, remains at issue. Negotiators from the EC and Canada indicate they favor relaxing quotas within the current MFA structure. The United States has proposed replacing the present system of bilateral quotas with some form of global quotas, under which an importer would specify its import quantity without regard to the specific source of the imports. Under the U.S. plan, liberalization would proceed through successive escalations of the global quota until it was too large to have any effect.

The supporters of the global quota claim the major benefit of the U.S. plan is that it allows market forces to govern competition among exporting nations, even during the transition period. By introducing more market forces initially, this plan favors countries with comparative advantage and discourages investment in countries who simply have favorable quota arrangements.

The U.S. plan, however, disfavors industrialized-country exporters because they were previously little constrained by quotas but would face the global quota on an even footing with developing countries. It would also disfavor countries generally which hoped to diversify into exports in this market, before they faced restrictive quotas. This plan would also leave the liberalization goal vulnerable to the same kind of erosion of support it experienced earlier in the MFA. Just as the 6-percent quota growth planned in the MFA was not enforced, the growth of the global quotas might not grow because it would be subject to the same political pressures. In 1987, a global quota with a 1-percent annual growth rate was narrowly defeated in the U.S. Textile and Apparel Act. This would have implied a declining share for imports to the United States. A similar provision was introduced in another bill in the spring of 1990.

Prospects for Change

The numerous attempts to control international agricultural prices through ICA's are mostly past. Several factors constrain the likelihood of their immediate resurgence, despite a history of frequent renewals following periods of failure. Widespread liberalization of government intervention indicates little support for the principle of government control. Expanded trade in substitutes has increased the complexity of controlling targeted submarkets and the difficulty of expanding them, particularly by invigorating substitutes such as beet for cane sugar, wheat and rice for less traded grains, and synthetic products for natural fibers and rubber. Products without such substitutes, like coffee, cocoa, and tea, face demand that is unresponsive to price declines, so enlarging the market is also unrealistic.

Most importantly, the history of ICA's is now read as little more than frustration in achieving price control. The value of information gathering is accepted and will continue to occupy intergovernmental organizations in many primary

products, but further experiments in active intervention are not likely unless there is a loss of faith in the relatively open markets favored today.

Notes

1/ This article uses ICA's in reference to international agreements and organizations focusing on trade of a single commodity regardless of whether the agreements include importer participation or attempt to regulate prices.

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The Safe Food Issue: New Nontariff Barriers?

by
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Abstract: Food safety regulations balance considerations of health, consumer prices, and farm income. In international trade, the regulatory balancing act is more complex because the physical, cultural, and legal distance between consumers and producers may be large. Food safety regulations have the potential to be used as protection measures, interfering with trade. They are one focus of the Uruguay Round negotiations and figure in the European Community's plans for market integration in 1992. While the two approaches to the task of harmonizing regulations differ, the processes are likely to enhance trade and provide mechanisms to enhance trade.

Keywords: Food safety, government regulation, agricultural trade.

Food safety regulations may pose some of the most serious barriers to agricultural trade in the 1990's. Public concern over food safety is mounting in the United States and abroad. Public opinion surveys show that many consumers doubt the assurances of government regulators regarding the safety of established tolerances for pesticide residues in fruits and vegetables. Consumer rejection of the pesticide Alar cost U.S. apple producers an estimated \$120 million in domestic and export revenues for 1988/89 (2). Animal rights activists and others object to new, as well as traditional, production methods for eggs, poultry, dairy, and meat, based on ethical, social, and economic arguments as well as allegations of health risks. The European Community (EC) has banned the use of natural and synthetic growth hormones in meat production, costing U.S. producers an estimated \$92 million in export sales in 1989.

People disagree over the role of government regulation in the food production and distribution system, over the proper criteria for setting regulations, indeed, even over the evidence regarding the presence and safety of chemical residues and additives in food products. In a single country, food safety regulations attempt to balance the often conflicting concerns of food safety, consumer prices, and farm income. In international trade, the regulatory balancing act becomes

more complex because the physical, cultural, and legal distance between consumers and producers may be large, and because food safety issues may be politically misused to protect domestic agriculture.

Differing food safety regulations have the potential to block international agricultural and food trade more effectively than traditional trade barriers, because they can create absolute import bans, as illustrated by the EC's ban on the production and import of meat derived from animals treated with growth hormones.

Food safety and plant and animal health regulations are a central focus of agricultural trade negotiations in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), and in the EC's plans for market integration in 1992. Harmonizing the diverse food safety regulations of the world's trading nations is a complex task. The GATT and the EC 1992 process are taking somewhat different approaches to the task, but together they could provide the technical and institutional means to more fully liberalize world trade in food and agricultural products.

Health And Safety Standards In GATT

Under Article XX(b) of the GATT, contracting countries are permitted to restrict agricultural trade, as necessary, to protect the health and safety of plants, animals, and humans.

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Food safety and sanitary regulations refer to all health- and safety-related rules regarding the production, processing, and distribution of animals and animal products. They include veterinary practices, drug residue tolerances, quarantine requirements, processing standards, and handling procedures. Phytosanitary and food safety regulations refer to health and safety rules for the production, processing, and distribution of plants and plant products. Sanitary and phytosanitary rules are intended to prevent the spread of plant and animal diseases and to protect the health and safety of consumers.

Each GATT contracting country is free to establish whatever sanitary, phytosanitary, and food safety regulations it deems appropriate, so long as they do not constitute disguised barriers to trade. Because countries have different attitudes toward government regulation and different production needs, they have established different standards. Inevitably conflicts arise between countries over what standards reflect legitimate health and safety concerns, and what are, in fact, disguised trade barriers.

In addition, the GATT Agreement on Technical Barriers to Trade, commonly known as the Standards Code, addresses the use of sanitary and phytosanitary regulations in trade.

The Standards Code requires signatories to notify and consult the GATT when setting or changing national regulations, and to follow an official dispute settlement process for resolving trade conflicts over technical barriers. Many have criticized the Standards Code because it lacks an effective dispute mechanism and because it applies only to the 40 signatories, rather than to all GATT contracting countries. Several agricultural exporters, including Australia, have not signed the Code, and so are not subject to its disciplines. Further, the Standards Code does not sufficiently address processing and production methods which are central to agricultural and food trade.

Food Safety Issues and EC Harmonization

The EC intends to eliminate all internal physical, technical, and fiscal barriers to trade as part of its plans for establishing a single, integrated market by the end of 1992. Technical barriers to agricultural and food trade include the divergent sanitary and phytosanitary regulations as well as labelling and packaging requirements of the EC member countries. Physical barriers to trade include frontier controls which delay transit of agricultural and food products across national boundaries, a serious problem for the transport of perishable products.

Eliminating EC internal frontier controls for agricultural and food trade will require that they adopt uniform harmonized standards for plant, animal, and food safety. Harmonizing standards for food and agricultural products across the EC,

where 12 sets of standards existed before, will have consequences for trade among EC countries, exports from the EC, and market access to the EC for other countries.

It is likely that the EC will harmonize standards at strict levels, but not at the level of the member state with the strictest level. Relatively strict tolerance levels for pesticide and herbicide residues are in effect in northern tier countries while more lenient tolerances are in effect for southern tier countries, because southern agroclimatic conditions require more extensive use of pesticides and herbicides. If the EC requires countries such as Spain, Portugal, and Greece to adopt stricter standards, it could adversely affect their production and reduce farm incomes.

The EC plans to adopt harmonized rules only on matters relating to public health, consumer protection, fairness of commercial transactions, and environmental protection. Where harmonization is not needed or cannot be reached, the principle of mutual recognition of national regulations and standards will be invoked. Mutual recognition means that each EC member country will accept the standards of other members as equivalent to their own. This strategy is fundamental to the success of the harmonization process, because it means that any product legally manufactured in one EC country will have access to all other member states' markets.

Theoretically, the principle of mutual recognition should apply to imports to the EC as well as to EC-produced goods, but it is not yet clear how it will operate in practice. If EC-wide standards are set, then third countries' products must comply. Mutual recognition could give exporters to the EC greater market access because they would only have to meet one EC standard instead of 12 national standards. 1/

It is not yet clear whether testing and certification results from third-country labs will be allowed. If they are not allowed, then subcontracting to EC labs could be a barrier to trade because of high costs.

It is also useful to remember that sanitary, phytosanitary, and food safety regulations are not the only barriers to agricultural and food trade. The EC discriminates against most food and agricultural imports through the variable import levy system of its Common Agricultural Policy (CAP). The variable levy increases the price of imports to EC levels or higher and thus limits market access. These types of border mechanisms are also being negotiated in the ongoing GATT talks under the agenda item of market access.

Food Safety and U.S.-EC Trade Conflicts

Trade disruptions have already occurred because of the EC's 1992 harmonization process. As mentioned above, the EC's ban on the production and importation of meat derived from animals treated with growth-promoting hormones has led to

the loss of a market worth approximately \$92 million to the United States. If the ban had been limited to those countries concerned with hormones as a food safety issue, then a significant portion of the trade would have continued. However, the need to "harmonize" the hormone ban across all 12 member states led to adoption of an EC-wide ban.

The EC's hormone ban illustrates an important aspect of trade disputes that result from food safety issues. It is generally recognized that some EC countries did have a food safety problem because of the misuse of growth-promoting hormones in the production of veal and beef.

EC livestock producers normally administered growth promotants with injections, and some EC producers injected animals with DES, a known carcinogen banned in the United States in the 1970's. In the summer of 1988, widespread reports in the West German media about the illegal use of growth promotants in veal production led to a total collapse of the veal market there. Continued reports of illegal hormone use in some EC countries have resulted in lower veal consumption.

U.S. producers do not use injections to administer growth promotants, but rather rely on implants of Food and Drug Administration (FDA)-approved growth promotants which gradually release small doses of synthetic forms of naturally occurring hormones. The consensus among American and international scientific groups is that the methods and products used in the United States are safe (6, p. 23-24). In fact, when approved growth promotants are administered correctly, no detectable traces remain in the meat. Some authorities argue that the meat is even healthier because it contains less fat. Moreover, beef produced in the United States has lower hormone levels than EC beef because EC consumers prefer bull meat.

Growth promotants cause animals to gain lean weight faster, thereby lowering production costs. EC producers would be at a cost disadvantage if imports of meat derived from animals treated with approved growth promotants were allowed, while the ban remained in force for EC producers.

Solutions to the dilemma have proved elusive in spite of the creation of a U.S./EC Joint Task Force which provided a framework for certifying imports of U.S. meat and meat products derived from animals not treated with hormones. The certification program has not resulted in an appreciable amount of exports to the EC because of marketing problems and economic disincentives. More recently, the EC has approved the importation of dairy cow offals which could result in U.S. exports to the EC of \$15-20 million and a commensurate reduction in U.S. retaliation because of the EC's ban.

Case of BST

The same type of dilemma appears to be developing over a new growth hormone called bovine somatotropin (BST). BST is a synthetic version of a natural hormone which increases milk production in dairy cows. BST promises to significantly lower per unit costs of milk production, and current scientific evidence supports the belief that it is safe. It appears that the United States and the EC may differ over approval of BST. If the United States approves its use and the EC does not, U.S. dairy products may be barred from the EC market. In the 1989/90 marketing year, U.S. dairy exports to the EC amounted to almost \$6.5 million.

BST is undergoing a rigorous testing procedure in the United States to determine whether it poses a threat to the health of the treated animals. Tests have already shown that milk from cows treated with BST is safe for human consumption. BST will not be approved for commercial use unless the consensus among researchers confirms its safety.

The EC has adopted a moratorium on the use of BST until the end of 1990. The European Commission is scheduled to present its definitive report on BST to the Council of Ministers in October, with a final decision on whether or not to allow its commercial use to be made by the end of the year. The European Commission is expected to report on the social and economic effects of BST on the dairy sector as well as on the scientific implications for human and animal health (1).

The EC argues that BST will increase the dairy surplus, that it will disadvantage small farmers, and that consumers don't want it. The United States argues that the EC's own GATT proposal requires health standards to be based on sound scientific evidence rather than socioeconomic impacts. Since BST is a naturally-occurring hormone which is present in all cow's milk, testing milk for BST cannot determine whether or not an animal has been treated.

The way in which the EC formulates food safety and plant and animal health regulations may create additional difficulties for the United States and other EC trading partners. Food safety and consumer preference issues are politically very sensitive in some of the member states of the EC, and the decisionmaking process may prove impervious to outside pressure. It has proven to be enormously difficult to reach a consensus on sensitive issues in the EC Commission, and decisions are often reached with little public involvement. Once the EC Commission reaches a consensus there is little that other concerned countries can do to influence it.

Further, there are no existing EC-wide regulatory bodies that oversee the development of food safety, health, and environmental regulations and their enforcement in the member

nations. Water and air pollution caused by agricultural production have prompted divergent national regulations such as a tax on manure production in the Netherlands intended to curb intensive farming practices. Such regulations may favor producers in countries having more lenient standards. An EC environmental agency has been proposed which would include a center to track nitrate pollution in the member states and might create more uniform EC-wide regulations and enforcement.

The EC has made significant progress in its testing and certification procedures which are crucial to food safety and trade. Within the EC, member states have agreed to test and certify meat safety at the points where consumption and production externalities occur, thus eliminating the need for border controls. This means that if the health or safety risk occurs at the point of production, the producing country would have the right and responsibility to regulate it. The manure tax in the Netherlands, mentioned above, is an example.

On the other hand, if the health or safety risk occurs at the point of consumption, as is the case with Salmonella contamination, the consuming country would have the right and responsibility to test and certify the product's safety. If this methodology were adopted in the GATT, and if trade dispute arbitration were based solely on scientific evidence provided by agreed-upon international scientific bodies, barriers to world trade in meat could be greatly reduced. Significant progress in the EC 1992 harmonization program has also been made in common nutrition labeling, packaging, and in development of qualifications for an organic food label.

The GATT and Solutions To Food Safety Disputes

The United States has proposed in the GATT negotiations to harmonize worldwide sanitary and phytosanitary regulations (GATT language for animal and plant health and safety) for agricultural trade on the basis of internationally accepted scientific evidence. At the April 1989 midterm review of the Uruguay Round, the agriculture ministers of the 96 member countries agreed to the principle of harmonizing health and safety standards.

They agreed to work toward the following objectives:

“(1) developing harmonization of sanitary and phytosanitary regulations and measures, on the basis of appropriate standards established by relevant international organizations including the Codex Alimentarius Commission, the International Office of Epizootics (OIE) and the International Plant Protection Convention (IPPC);

(2) strengthening Article XX (of the GATT) so that measures taken to protect human, animal or plant life or health are consistent with sound scientific evidence and use suitable principles of equivalency....”

There appears to be considerable agreement among the final proposals tabled by the major negotiating groups since the midterm review in the area of sanitary and phytosanitary regulation. The U.S. proposal would establish “a mechanism for notification, consultation and dispute settlement which would ensure that measures taken to protect animal, plant and human health are based on sound scientific evidence and recognize the principle of equivalency.”

The EC proposal would base harmonization under the auspices of international organizations like the Codex, the OIE, and the IPPC. The EC proposal asserts the need for “application of more stringent national standards in particular circumstances” but it does not argue for the use of social and economic factors in setting standards.

The EC proposal agrees with the U.S. proposal in accepting “suitable principles of equivalency” and in calling for more effective procedures for notification, consultation, and dispute settlement. The proposals of other countries are similar. Japan argues that “allowance should be made for differences in sanitary conditions, geographical conditions, and dietary customs,” and calls for clarification of the “principle of equivalency.”

The GATT is very important to the EC's harmonization process, particularly in regard to food safety issues. It is one way of reminding the EC that it belongs to a larger community of nations and cannot develop its own food safety and environmental program at the cost of disrupting world trade without reference to internationally accepted rules. The EC agrees that the GATT must be provided with the ability to solve disputes which implies an adherence to the basic principles of the GATT regarding sanitary and phytosanitary rules.

The Codex and the International Plant Protection Convention of the Food and Agriculture Organization (FAO) of the United Nations could prove to be a valuable and immediately available source for the enormous task the EC has set for itself. The internationally recognized standards of these international organizations, agreed to by representatives of over 100 countries, are set at relatively strict levels and are immediately available to the EC.

These organizations could also provide standards and scientific evidence to enhance the settlement of disputes within the GATT. An agreement in the GATT would be very useful for the EC because international disputes seem certain to arise on food safety matters as a result of the 1992 harmonization process. In contrast, a failure in the GATT could lead to greater divergence in food safety regulations and increased use of food safety regulations as trade barriers.

The Codex Alimentarius Commission is a subsidiary of the Food and Agriculture Organization (FAO) of the United Nations and the World Health Organization. The Codex was established in 1963 to facilitate world food trade by establishing internationally accepted standards based on accepted scientific knowledge. Representatives of 135 countries serve on the Codex Commission, which is divided into 14 commodity subcommittees and 7 general committees dealing with subjects such as food additives, pesticide residues, and food labeling. Codex expert committees comprise representatives from government regulatory agencies, the international scientific community, and industry.

The International Office of Epizootics, known by the initials of its French name, OIE, is the world's oldest international veterinary organization. It was formed in 1924 and now has over 100 members. Its goals are: to develop and maintain a worldwide animal disease reporting network, and to facilitate world trade by minimizing the risk of spreading livestock diseases. The OIE recommends sanitary regulations for trade in animals and animal products and establishes appropriate testing procedures.

The International Plant Protection Convention (IPPC), like Codex, is a subsidiary of the FAO. The IPPC focuses on preventing the spread of plant-borne diseases and pests, and developing plant quarantine requirements for international trade. The IPPC was formed in the 1950's and now has 88 member countries.

Notes

1/ See the article by Gardiner, Neff, and Kelch, above.

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Eastern Europe: The Transition from Plan to Market

by

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Abstract: Eastern Europe is experiencing political and economic reform that will profoundly affect its agricultural production and trade through the 1990's. The removal of stifling, centrally-planned, production directives and resource allocation could lead to a more efficient, productive, and competitive agricultural sector in the region. Elimination of low, heavily subsidized consumer prices for basic foodstuffs and substitution of higher-value food and consumer goods could result in slow growth, or even decline, in per capita consumption of basic foodstuffs. The combined effects of increased productive efficiency and stagnant or declining consumer demand could bring about a domestic surplus of traditional foodstuffs available for export. Results of an exercise projecting world agricultural production and trade to the year 2000 indicate that, if one assumes only modest productivity gains and modest consumption growth, Eastern Europe could produce sizable surpluses for export. The projections suggest that Eastern Europe might export surpluses of grains and meats, but continue to be a net importer of oilseed products.

Keywords: Eastern Europe, Council for Mutual Economic Assistance (CMEA), central planning, reforms, market orientation, currency convertibility.

All the countries in Eastern Europe, except Albania (at this writing), have experienced substantial political and economic upheaval in the past year. In all cases, previously existing Communist governments were replaced by noncommunist or reform-minded Communist governments. Thus far, Poland, Hungary, East Germany, and Czechoslovakia have ended Communist rule. Although Bulgaria, Romania, and Yugoslavia are still ruled by Communist Parties, their leaders are giving increasingly serious consideration to significant political and economic reform. Following the conservatives' victory in East Germany's recent election, economic and financial unification with West Germany is scheduled for July 1990 and political union is all but inevitable.

The political reforms of the past year have led to varying degrees of economic reform. Poland introduced a series of economic reforms between August 1989 and January 1990 that transformed the economy from mainly centrally planned to mainly market oriented. Hungary increased the pace of its reform program, established in 1968, and is approaching a market-based economy, though without the traumatic transition experienced in Poland.

Czechoslovakia has announced its intention to make a transition from planned to market economy, and will cut, but not eliminate, consumer subsidies in July 1990. It is also beginning the privatization process, but is proceeding more cautiously than Poland. The Czechoslovak Government is reluctant to subject the population to economic shocks similar to Poland's, but economic conditions are not as severe as Poland's.

In January 1990, Yugoslavia and Poland introduced convertible currencies (Yugoslavia's pegged to the Deutschmark), implemented strict wage controls, freed up most prices, and opened up foreign trade in agricultural products even further. In both countries, the attempts to break severe inflationary spirals appear to be successful. Czechoslovakia aims to introduce currency convertibility by January 1991.

To date, Bulgaria and Romania have not implemented reforms as far reaching or economywide as those in Poland, Hungary, or Yugoslavia. However, both governments have removed many of the previously imposed restrictions on private landholdings and have given more incentives to private producers—in Bulgaria, private farmers are even allowed to export directly and retain a portion of their hard currency earnings. Both governments have removed virtually all controls on procurement, allowing private and socialized producers to sell to whomever they want. Furthermore, officials in both countries are engaged in serious discussion of major land reform, possibly involving redistribution of socialized land to private farmers.

Economic Issues That Must Be Addressed

To varying degrees, the Eastern European countries face similar issues during the transition from plan to market. These issues include the pricing system, heavy subsidies, inflation, privatization, foreign debt, currency convertibility, and the system of foreign trade.

Currency convertibility is an important issue having wide-ranging consequences. Previous restrictions and limits on convertibility have seriously hampered the East Europeans' ability to trade freely on world markets. Lack of currency

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convertibility is also a serious impediment to the influx of badly needed foreign capital into these countries. Convertibility guarantees foreign firms' ability to repatriate profits. Without that guarantee companies' investment plans are significantly more complicated and risky, a major disincentive to investment. Foreign capital will be important to the countries of the region as they face inflation and foreign debt problems.

Inflation

Inflation looms as a serious problem that will severely limit these governments in responding to disruptions during the transition from plan to market. Poland's experience during the latter half of 1989 is a graphic illustration of this problem. In that country, years of deficit financing of wage increases and large price subsidies left a sizable monetary overhang. Consumers accumulated large cash balances as incomes rose, prices of staple goods were subsidized and maintained at very low levels, and supplies of nonstaple consumer goods were limited. Once the Polish government freed retail prices, consumers used these accumulated money balances to bid up prices. Removal of retail subsidies placed further upward pressure on prices.

Except for Yugoslavia, this same sort of monetary overhang exists throughout the region, and there is a real danger that the other countries will experience similar inflationary pressures as their governments begin to eliminate subsidies and remove price controls. Hungary, for example, which removed most consumer price controls in January 1990, is already watching its inflation rise above the target level.

Poland and Yugoslavia have now successfully broken their inflationary spirals. Both governments accomplished this through a balanced budget, drastic reductions in government spending, strict controls on wage growth, and the curtailment or elimination of subsidies. Tight fiscal and monetary policies have been imposed, and the other countries are in the process of implementing similar policies. The Czechoslovak Government, in particular, has learned a lesson from the Polish experience and is attempting to impose strict fiscal and monetary controls before liberalizing prices. The short-term result will be substantial economic hardship throughout the region.

These economies are facing potentially substantial declines in production and income, and governments will be unable to undertake expansionist policies to offset these declines. Strict economic policies imposed by these governments are forcing them to halt their longstanding practice of subsidizing unprofitable enterprises from budget revenues or through easy credit. Thus, it is anticipated that many enterprises will fail, and unemployment will increase sharply. An economic decline appears necessary to eliminate inflationary forces and bring the economies back into balance after years of plan-enforced imbalances.

Privatization

Privatization of largely state-owned economies is a major task facing these countries. While currency convertibility and repression of inflation are fairly straightforward policies, the process of privatizing large economic entities throughout the economy is a complicated and potentially inequitable process.

Determining the value and method of distribution of state-owned enterprises is a major problem. But Eastern European government officials agree to a varying degree that privatization needs to occur in order to introduce competitive market forces and the incentives of private ownership. Furthermore, there is a general recognition that privatization must occur in the agricultural input and product procurement sectors, as well as in farming.

In Poland, most primary agricultural production is already in private hands, and latest reports indicate privatization is now spreading rapidly in the product procurement sector. But the Polish farm input sector remains state-controlled, and farmers complain about the poor quality, limited selection, and high prices of inputs. The still incomplete privatization in Poland has revealed bottlenecks that prevent or diminish the positive effects of competition in privatized sectors.

Farmers face excessively high and rigid input prices, which put a floor under the prices at which they can market their output and make a profit. Currently that price floor has proven to be too high and, following the elimination of subsidies, consumer demand has fallen to a level that cannot support the existing extensive agricultural sector. Input prices remain high even though the erosion of farmers' real income has caused a drop in demand. If the input markets were competitive, it is unlikely that input prices would remain high and rigid in the face of declining demand for inputs.

Compared with most of the countries of the region, Poland has an advantage in privatization because over 70 percent of its farms remained in private hands under Communist rule. However, the Polish land market has been highly restricted, resulting in very small private farms. A more flexible land market could lead to more efficient, larger farms. The other countries must deal with privatization in all three sectors of the agroindustrial complex at once.

Foreign Debt

Foreign debt is a severe problem for Poland, Hungary, Bulgaria, and Yugoslavia (table F-1). During the 1970's and early 1980's, these countries borrowed heavily to maintain domestic consumption levels while undertaking partial reform measures.

The partial reforms, for the most part, failed to stimulate economic growth or reduce accumulating economic imbalances.

Table F-1--Eastern European gross hard currency debt,
end-year 1988

Country	Total debt 1/ Billion dollars	Per capita debt 2/ Dollars
Bulgaria	7.8	870
Czechoslovakia	6.7	430
Hungary	19.3	1,820
Poland	39.2	1,030
Romania	1.9	80
Yugoslavia	18.7	790

1/ Total gross debt in billions of U.S. dollars. 2/ Gross per capita debt in U.S. dollars.

Source: PlanEcon Report, Vol. V / Numbers 42-42, pp 54-5.

This left these countries with high levels of debt and poorly performing economies. This debt limits governments' ability to borrow hard-currency funds to import investment goods or contribute capital to joint ventures with foreign firms.

The debt also requires substantial hard currency exports to service debt payments. But, as mentioned above, industrial goods manufactured in the region are generally not competitive on world markets because of quality and service problems. With the exception of low-grade coal, which has been a prime contributor to environmental pollution, none of the East European countries has significant endowments of natural resources for export. Thus, agricultural exports appear to offer the greatest potential to generate hard currency earnings until industrial product quality and service issues are addressed.

The Foreign Trade System

The ability of firms to make import and export decisions based solely on world prices and the profit motive is essential for an economy desiring to be well integrated into the world economy. The forces of open foreign trade keep domestic economic sectors competitive on world markets. Historically, foreign trade in centrally planned economies was carried out through state-run organizations holding a monopoly over all trade of particular groups of commodities or sectors of the economy. Firms were essentially insulated from the negotiation process and from world prices, whether importing or exporting. As a result, most Eastern European firms are not competitive on world markets.

East European countries have, at least partially, freed up the foreign trade sector in the past decade, but the current reform process calls for unlimited enterprise freedom in foreign trade activity. Unfortunately, because of the issues discussed above, limits may be placed on imports over the next few years. Until complete currency convertibility is achieved and foreign debt problems ease, some sort of government control or licencing of enterprise trade decisions involving hard currency will likely continue. Still, it appears that, in general, world prices are being increasingly transmit-

ted to domestic firms, and import decisions are more frequently based on a firm's ability to earn or purchase hard currency.

East Germany's transition is a special case because of its approaching unification with West Germany. Thus, continued analysis of East Germany as an independent country depends on the nature and extent of the unification process.

Projections of East European Agriculture to the Year 2000

What impact could the transition from plan- to market-based economies have on agricultural production, consumption, and trade? Comparisons of current yields between East Europe and Western Europe indicate that East Europe's yields are significantly lower for most grains and all live-stock products (table F-2). Furthermore, East European grain yields have fallen further behind yields in the European Community (EC) since the prewar era. At that time, the region stretching from Poland, Romania, Hungary and into the Ukraine was considered Europe's breadbasket. Much of this area is contained in present-day East Europe.

Prior to World War II, the East European countries (excluding Germany) were sizable net exporters of all grains and meat products. The region is still currently a net exporter of meat, but is now a net importer of grains. Most grain imports come from Western hard-currency countries, and most meat exports go to the soft currency countries comprising the Council for Mutual Economic Assistance (CMEA). Thus, current agricultural trade patterns for these commodities add to the hard currency shortage.

Part of the growing yield differential between East and West may be due to EC farm policies that encourage farmers to maximize yields. Many East European producer prices for meat and grains are lower than EC prices when measured at official exchange rates. Using more realistic exchange rates, East European producer prices are even lower. The yield differences could therefore generally be attributed to the different economic systems and price policies in the two regions rather than to different natural conditions.

Table F-2--Comparison of Eastern European and EC-10 yields,
1981-85 1/

Commodity	Eastern Europe	EC-10	Percent gap 2/
Wheat	3.71	4.82	30
Barley	3.53	4.50	28
Corn	4.72	6.60	40
Other coarse grains	2.58	3.78	47
Beef	72.40	90.18	25
Pork	99.66	129.99	30
Milk	2,730.00	4,300.00	58

1/ Yields for grains are metric tons per hectare; for meats, metric tons per unit of inventory; and for milk, metric tons per animal, 1985 only. 2/ Percent gap is equal to EC-10 yield divided by Eastern European yield.

Sources: USDA-ERS, Agricultural Performance in Eastern Europe, 1987, Staff Report No. AGES 881025, 1988; USDA-ERS, Western Europe Agricultural and Trade Report, RS-89-2, 1989; and USDA-ERS, Agricultural Statistics of the European Community, 1960-85, Statistical Bulletin No. 770.

Still, soils in the northern parts of Poland and East Germany are generally sandy and weather conditions are uncertain. Wheat will not grow well here, but rye, triticale, and barley will. This region may be better suited for livestock grazing than grain production. Current EC yields can reasonably be taken as a measure of what they could be in Eastern Europe under a market environment.

On the consumption side, East Europeans already consume relatively high levels of meat, milk, grain, and sugar products per capita, given their level of economic development compared with the EC. East Europe's per capita gross national product was 63 percent of the EC's in 1986, according to the CIA Handbook of Statistics. The PlanEcon consulting group says this number should be discounted to 48 percent. Yet per capita meat consumption in Eastern Europe was 84 percent of the EC level in 1986 and well above the levels of other countries having a similar low level of economic development.

These high per capita consumption levels were the result of very low consumer prices for staple food products and a nearly complete lack of substitutable consumer items to buy. Because meat and other staple food products are already consumed at relatively high levels, consumption could easily stagnate or decline when consumers face high real food prices and increased supplies of diverse nonstaple food and other consumer goods that market economies enjoy.

To capture the effect of East European market reforms on world agricultural markets, the following was assumed:

- **Productivity gains** — Reforms allow productivity increases in the Eastern European agricultural sector. Productivity increases are assumed equal to one-half the yield differentials found in table 2.
- **Income growth** — Income growth is assumed to average 2 percent annually. This average should capture the

effect of a potential initial decline in incomes, followed by more rapid growth. Organization for Economic Cooperation and Development (OECD) countries' income growth is assumed to average 2.5 percent annually.

- **Producer and consumer prices** — East European farmers and consumers no longer receive subsidies from the state for agricultural products. All production and consumption decisions after reform are based on world prices.
- **No other policy shocks** — Agricultural policies in the rest of the world do not change in any major way in response to the Eastern European reforms

Based on these assumptions, East European agriculture is estimated to be a potential net exporter of meat and grains by the year 2000 (table F-3). Meat exports are estimated at three times the 1986 export quantity. Projections based on past production and consumption trends, but no assumption of economic reform, indicate that Eastern Europe was already trending toward increased net exports. According to model results, though, the impact of reform would be to increase potential meat exports 10 percent above trend.

Projections for grain trade indicate that, with the successful implementation of economic reform, East Europe could potentially export up to 5.3 million tons by the year 2000, as opposed to 1986 imports of 3.5 million tons. Trend-based projections assuming no reform also show Eastern Europe becoming a net grain exporter, but only of 1.8 million tons.

On the basis of the projections, it appears that reform will have little impact on trade in oilseeds and products. Under a non-reform scenario, net imports are estimated to be about 5.9 million tons (soymeal equivalent) by the year 2000, an increase of around 25 percent from 1986 imports. With reform, imports are projected at 5.7 million tons. The small decline in oilseed product imports, despite increased meat

Table F-3--Projections of possible Eastern European
net imports, 2000

Commodity	1986 base year	Trend only	Reform	Reform impact 1/ Percent
	Million metric tons			
Meat	-1.117	-3.046	-3.361	+10
Grains	3.225	-1.787	-5.333	+226
Oilseed products 2/	4.605	5.900	5.713	-3

1/ Reform impact is the percentage difference between the reform and trend only results. 2/ Imports of oilseeds and meals, all converted to soymeal equivalent.

Source: ERS estimates.

production, occurs because of the assumption of productivity gains that allow for increased production without increased input use.

However, these projections assume no change in the feed rations. Currently, there is a shortage of protein throughout the region, which reduces feeding efficiency. It is quite possible that, with reforms, farmers would increase the protein content of their compound feed, in which case reform could result in a larger increase in oilmeal consumption. Because agronomic conditions preclude significant increases in output, any rise in consumption will mean higher imports.

Productivity gains and price adjustments used in the reform scenario are, if anything, on the low side. Only partial closure of the productivity gaps was allowed, and the effect of

overvalued official exchange rates was not incorporated. Higher productivity gains than those assumed here would add to exportable surpluses. Accounting for overvalued exchange rates would imply even greater incentive to produce, and even more disincentive to consume after reform.

Conclusion

The transition from planned to market economy will not be easy. In the short term the process will require sacrifice on the part of the people and will heavily constrain government policy. If the transition is successful, Eastern Europeans would be potential competitors on world grain markets and possibly acquire a larger share of world meat exports. Potential market possibilities in Eastern Europe are more likely to be found in agricultural and food processing input products, nonstaple and high quality food products, and nonfood consumer goods.

Economic Restructuring in the USSR and Its Potential Impact on Agricultural Trade

by
Edward C. Cook*

Abstract: The impact of economic reforms in the USSR on agricultural trade will depend on the extent to which the Government cushions the domestic economy from shock. Though unambiguous conclusions are not possible, there is reason to suspect a potential decline in Soviet agricultural trade as a result of reform, at least in the initial stages. Shifts in trade structure are also likely. It may be well into the future before significant agricultural market reform is realized.

Keywords: Soviet agriculture, economic reforms, markets, prices, currency convertibility.

The USSR is in the midst of major changes in how its economy functions. Traditional reliance on centralized, inflexible methods of resource distribution, and a system characterized by weak linkage between efficiency and rewards have led the country to a developmental impasse.

This is reflected not only in disappointing Soviet economic growth rates and increasing imbalances within the economy, but also in the failure over time for the USSR to become integrated into the world economy. As time passed, it became clear that the traditional Soviet growth strategy entailed undue investment burdens (investment's large share of gross national product) and that the system could not keep pace with technological advances in market economies.

President Gorbachev has attempted to revitalize the Soviet economy by introducing elements of a market system. The hope is to create a mixed planned-market economy which will capture the efficiency and dynamism of Western economies, without sacrificing crucial aspects of socialism.

Gorbachev, and reform-minded thinkers in general in the USSR, have been hampered in this effort by the weak foundation of Soviet economic theory after 70 years of Marxist orientation. Moreover, it is not clear which defining aspects of socialism are above compromise. (An important question is how Gorbachev's desired socialism differs from traditional Western social democracy.) While the USSR embarks on the search for a plan-market hybrid, countries of Eastern Europe which have preceded the USSR down this path (most notably Poland) are moving toward full-fledged privatization of their economies.

The impact of the Soviet economic restructuring on agricultural trade clearly depends upon the nature and direction of that restructuring. Aspects of a restructuring program that appear likely at present include the following: movement of domestic prices toward world market levels; a significant tightening of the banking and credit system; further relax-

ation of central control over foreign trade (including more developed internal markets for hard currency); and further development of small-scale business and cooperative activity.

What remains in greater doubt is the extent to which capital and land markets will be developed, how the state will divest itself of productive assets, the future role of price controls in wholesale and retail markets, and the extent to which the ruble will become convertible.

Movement to a full-fledged market economy could result in significant changes in Soviet agricultural trade. Shifts in relative prices internally would be very large, and for the first time consumers' preferences and comparative advantage would replace planners' preferences in determining trade.

In the short run (before economic reforms result in greater competitiveness of Soviet exports), Soviet hard-currency revenues are likely to remain very tight. The share of hard-currency revenues allocated to agricultural imports by planners has been large, roughly one-third. Given some movement toward market reform (reduction or elimination of subsidies and creation of a market for hard currency), it is possible, though not likely, that this share would increase. (For an argument about why it may in fact increase, see (5)).

Questions Facing Gorbachev

The task facing Gorbachev is not simply revitalization of economic growth rates, but achievement of increased production efficiency. During the 1980's it became customary in the USSR to distinguish "extensive" from "intensive" growth. The former was the traditional Soviet strategy, which depended on large infusions of inputs. Intensive growth became synonymous with improving total factor productivity (increasing the aggregate output/input ratio). Now, Soviet policymakers understand that intensive growth alone is not enough. Consumer preferences must be integrated into economic activity if reform is to be meaningful.

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The first 5 years of Gorbachev's economic restructuring effort (1985-89) witnessed weak efforts at economic reform which relied primarily on improved cost-accounting for enterprises and a greater reliance on state-set normatives to guide economic activity. These ideas proved inadequate at limiting arbitrary state interference in enterprise activity, at increasing incentives and flexibility, or at achieving the desired improvement in total factor productivity.

This failure, combined with the increasing significance placed on consumer preferences, led to acceptance of markets as the key to successful reform. The questions now are what sort of markets? How are they to be established? A corollary consideration is the degree and manner of state control over markets and economic activity.

The Weak State of Soviet Economic Theory

Unfortunately for Gorbachev, there is little theoretical foundation in the USSR for dealing with these questions. (This is not the case in many Eastern European countries, notably Hungary and Poland.) For 70 years there has been little exposure to Western economic theory. The appearance of supply-demand analysis in the Soviet literature remains an extremely rare event.

Furthermore, traditional economic thinking in the USSR is acting as a brake on adoption of a market system. Through Marxism, Soviet economic thought has inherited a bias toward primary production, to the detriment of consideration of processing and distribution. The traditional success indicators that Soviet policymakers established for the economy were tons of steel, oil, cement, etc. produced. Production of the means of production became the focus of investment, to the detriment of consumer goods industries, wholesale and retail trade, and other services.

To this day there is a strong mistrust of middlemen. The notion that marketing and distribution activity is an important source of value added, as determined by consumers, is generally not accepted by the population.

The reliance on administrative allocation of resources is based, in large part, on rejection of markets. In the traditional Soviet environment, markets are mistrusted. The state's pursuit of a unitary interest through administrative control is viewed as somehow morally superior to the market's coordination and reconciliation of opposing interests. Over time, mistrust and avoidance of markets has led to a situation where most Soviet economists do not understand how a market system works. Particularly troublesome is the self-equilibrating feature of markets. For many, the notion of market-determined prices is still synonymous with anarchy and exploitation.

The USSR's traditional economic system has left many Soviet economists with only a weak appreciation of trade-

offs. Under the traditional approach, planning insured that growth occurred "from achieved levels." That is, planned targets for enterprises were set as a percentage increase from the previous year's actual achievement. In this way, all enterprises shared in growth. This resulted in stability in the system, but also in a decidedly sub-optimal allocation of resources. This approach led to outright rejection of marginal analysis as a theoretical basis.

In addition, the idea that pursuit of efficiency can result in some losers remains foreign to Soviet economic thinking. Soviet policymakers and the bulk of the population do not accept that pro-efficiency changes will entail sacrifices of equity or social guarantees. (It took Poland virtually all of the 1980's to come to this realization.)

Between Plan and Market

The changes that Gorbachev has introduced since 1985 have moved the Soviet economy away from the centralized administrative method of control. Two of the most important changes were increased economic autonomy for the republics (giving them greater say over resource distribution and use in their jurisdictions) and a new law on state enterprises, which gave state enterprises more say over product mix, wage payments, and investment. One reason for the deepening economic crisis in the USSR toward the end of the 1980's was that the traditional administrative system was increasingly less capable of balancing economic activity, while markets were not sufficiently developed to do the job.

On the demand side, the state increasingly lost control over the relationship between wage payments and productivity and was unwilling to choke off demand through higher prices. The accumulating excess liquidity in the hands of the population posed a growing threat to successful transition to market prices. On the supply side, an unwillingness to enforce financial discipline at the enterprise level, including maintenance of a decidedly negative real rate of interest, and the lack of progress on price reform, insured continued wasteful use of investment resources.

Gorbachev has stated that his goal is a mixed planned-market economy, which incorporates the best of both socialism and capitalism. What this means is very unclear. Countries of Eastern Europe have long striven for a "third way" between a Western market system and the traditional Soviet model. Hungary has had some success fusing plan and market, resulting in one of the highest standards of living in the region. The Hungarian model, though, has failed to make Hungarian enterprises competitive in world markets and has resulted in a large foreign debt. Hungary has now set its sights on moving closer to a market system. The Yugoslav experience with decentralization within a socialist system has also exhibited serious shortcomings as a developmental model, as witnessed by extremely high rates of inflation and unemployment, and actual economic contraction during the 1980's.

Based on his statements since the beginning of 1990, it appears that Gorbachev recognizes the futility of aiming for either the Hungarian or Yugoslav models. But it remains particularly unclear where Gorbachev would like to see the Soviet economy end up. Attempts to clarify, and possibly redefine, the essential aspects of socialism have been appearing in the Soviet press and professional literature. It is quite conceivable that Gorbachev's vision of a humane and democratic socialism differs in no essential way from Western social democracy, particularly the Swedish model. (Whether the Swedish model is, in fact, an appropriate goal for the USSR is open to question.)

A potentially significant step in favor of market reform came in March of this year when the Government reversed itself and rejected a program, that had been advanced by Premier Ryzhkov and adopted in December, aimed at economic stabilization and recovery. The rejected program bore the imprint of conservative-minded economists. It called for delay of development of markets in the USSR until 1993. Instead, it would have relied during the next three years on a massive reallocation of resources within the economy, which would be guided by traditional bureaucratic methods. The logic was to overcome current imbalances in the economy by "flooding" the market with consumer goods and thereby improving the environment for reform.

The new reform approach recognizes the futility of attempting to balance the economy *prior* to economic reform. But, at the time of this writing, no coherent reform package had been formulated to replace the Ryzhkov program. Possible elements of a new program include earlier introduction of price reforms and divestiture of state-owned enterprises, creation of a stock market, an overhaul of the tax system, and banking and credit reform.

It appears more likely than ever before that radical changes in the operation of the Soviet economy will eventually be adopted, resulting in full integration into the world economy. This will mean creation of true markets for capital, land, goods and services, convertibility of the ruble, and a greatly reduced role for subsidies. The time required to implement these changes is anybody's guess. Because of the adjustments required by such a reform, the economic and social dislocations could potentially be severe, which might temporarily halt or reverse progress toward reform. Soviet economists also need time to develop the expertise necessary for overseeing radical market reform.

Equity-Efficiency Tradeoffs

The pace of economic reform in the USSR will depend on recognition and acceptance by policymakers, and the population at large, of the tradeoffs associated with efficiency reforms in the economy. A key aspect of the Government's reform "platform," to this point, has been that living stan-

dards would at least be maintained, if not improved, during the period of economic restructuring. (This is exactly the position of the Government and Solidarity in the Polish reform debate of the early 1980's).

Such a promise cannot be maintained. In fact, attempts to adhere to it are a primary reason for the ballooning of the state budget deficit since 1985, and the consequent growth in the money supply and inflation. Instead, a program of targeted assistance for population groups at greatest risk, rather than across-the-board compensation, would appear to be an essential part of a reform strategy.

Equity/efficiency implications for agriculture are particularly sharp. Agriculture is in the most dire financial situation of any major sector of the Soviet economy. Ill-founded government investment, pricing, and credit policies since the mid-1960's have resulted in an agricultural sector characterized by extremely wide discrepancies in efficiency among farms (1).

Keeping in mind that agriculture is the repository for a significant number of disguised unemployed or underemployed people in the USSR, the dislocation in a pro-efficiency reform of agriculture could be particularly severe. Development of alternative employment opportunities in the rural economy would help smooth this transition, as it did in China in the early 1980's.

Potential Agricultural Trade Impacts

For the purposes of discussing potential agricultural trade impacts, we will assume that the USSR makes steady progress over the next few years toward real market reforms. The pro-efficiency logic of the Soviet economic restructuring requires adoption of true markets for inputs and output (i.e., markets characterized by equilibrium prices and adequate competition), elimination of foreign trade barriers (with internal markets for hard currency, if not full ruble convertibility), reduction of government subsidies, and establishment of financial discipline through reform of the banking and credit system. Agricultural trade can be affected either through changes in the overall value of trade, changes in the commodity structure of trade, or changes in trading country shares.

The ability of the USSR to import, obviously, will be tied to its ability to export. Given the expansion of Soviet net foreign debt since 1985, a debt-service ratio that is now about 25 percent, and the experience of Eastern Europe's reliance on indebtedness, the USSR is not expected to make more extensive use of foreign credit during the restructuring process than it has in recent years. An exception is credit offered on concessional terms.

In the short run, before reforms have a chance to improve the competitiveness of Soviet exports on world markets, Soviet

export earnings are expected to remain tight. The impact of moving toward market prices internally, of exchange rate policy during reform, and of movements in world prices for the USSR's traditional exports (oil, natural gas, and gold) will all have a bearing on Soviet export earnings. It may be that adoption of market-determined trade could significantly alter Soviet export earnings either up or down, even in the short run.

Movement toward comparative advantage will also have a primary bearing on the allocation of available hard-currency earnings among competing uses. Unfortunately, the task of using current Soviet cost and price data to ascertain the impact of movement toward liberalized trade in a market setting is highly problematic.

Work recently completed in USDA deals with the more tractable problem of trade impacts of liberalization in the agricultural sector taken alone (6). For analysis of Soviet trade liberalization, internal market reform within the USSR was assumed. The impact of market reform was reflected in shifting demand functions outward from those which reflect planners' preferences, to demand functions reflecting consumer preferences. Market reform was also assumed to have a positive impact on production efficiency, resulting in an outward shift in supply.

Because the analytic framework used considers only the agricultural sector, it could not incorporate potential impacts of reform from other sectors of the economy, such as changes in the agricultural input industries, or implications of comparative efficiencies among sectors. With these reservations in mind, the large initial price distortions between the internal Soviet economy and world markets, trade liberalization and internal market reform result in a shift in imports away from grain, particularly wheat, in favor of meat.

Additionally, there is some indication that after reform, the USSR would be competitive on world markets as an agricultural producer. In estimating Soviet producer and consumer subsidy equivalents (PSE's and CSE's) 1/ for major agricultural commodities, Cook, Liefert, and Koopman found that given an exchange rate of 2.5 rubles or more to the U.S. dollar, Soviet agriculture is competitive in terms of average costs (2). That is, average domestic producer prices are lower than world prices.

What exchange rate would make Soviet agriculture competitive in terms of marginal costs is complicated by the problems discussed above—defining relevant Soviet marginal costs. (It is comparison of marginal cost with import prices that should determine whether a country produces an extra unit of output domestically or imports an extra unit.)

Market reform itself will have an important bearing on eventual Soviet competitiveness in agriculture. Comparison of

Soviet animal and crop yields with those of other countries indicates room for improvement within the USSR, particularly for the former. The very reason for adopting a market system is the belief that producers, in fact, will become more efficient, and this belief seems justified. But because these improvements hinge on changes elsewhere in the economy (particularly industry), it may take a number of years before they are realized.

Anticipated improvements in Soviet efficiency in agriculture will be influenced also by changes in production costs resulting from adoption of markets for inputs (including market-clearing interest rates for capital). If these costs increase significantly for agriculture, expected outward movement in supply curves will not be as large, or could conceivably be fully negated. This is even more true in the short run, before the quality of the support agriculture receives from the rest of the economy has had time to improve.

Western estimates of a current equilibrium exchange rate between the ruble and the dollar range as low as 3 rubles to the dollar to as high as 6 rubles or more. The current black market (i.e., restricted) exchange rate is 15-20 rubles to the dollar. An exchange rate anywhere near this high would make the allocation of resources to agricultural production within the USSR highly attractive.

Another implication of the PSE/CSE work is that with exchange rates as high as 2.5 rubles to the dollar, adoption of world market prices results in radical increases in consumer prices for food in the USSR (2). Prices in state retail stores, where most food commodities are marketed, would have to increase by two to three times to be consistent with fully liberalized trade. With a higher exchange rate, the burden on consumers increases.

Though retail food subsidies are not expected to be fully eliminated, the demand-dampening implications of moving to a market system are clear. It could be that demand is dampened sufficiently to eliminate currently widespread food rationing schemes (either rationing cards or lines), and result in excess supply at current trade levels.

A comparison of per capita meat consumption among developed market and non-market economies shows that the USSR is on the low end of the European range, but actually exceeds, or is quite close to, a number of developed Western countries, including Norway, Sweden, the United Kingdom, and Italy (3). Given the USSR's level of economic development, this comparison suggests that Soviet citizens eat more meat than they would if they had a market economy. The implication is that market reform of the economy and trade liberalization will dampen demand for meat and, thereby, the demand for feed.

Elimination of planners' preferences in determining trade will have some specific implications for the commodity and trading partner structure of agricultural trade that can be identified now. First, bilateral trade relations with the Council for Mutual Economic Assistance (CMEA)—the Soviet trade bloc—have already been disrupted by changes in Eastern Europe. Most of those countries are now refusing to trade with the USSR on a basis other than world market prices.

The USSR's failure to close trade deficits with these countries, as well as diversion of food supplies to internal requirements in Romania, has left it without traditional supplies of meat, fruit, and vegetables. In response, the USSR has contracted for U.S. poultry, Canadian pork, Australian mutton, and other nontraditional meat suppliers to close the gap. Whether this situation will persist after economic reform settles out in the region is unknown, but it is unlikely that eventual post-reform relations will exactly mirror the traditional bilateral trade relations of the past.

Planners' control of import decisions has regularly resulted in a bias against oilmeal imports. Soviet feed rations, and mixed feeds in particular, are sorely deficient in protein. Pricing and other incentive distortions in the mixed feed industry result in lack of interest in protein meal use by mixed feed producers. Why this situation has persisted for so long is a mystery, but recent discussion in the Soviet press suggests that those controlling the purse strings do not understand the qualitative differences between corn and soybean meal and instead draw straight comparisons of price (4). This distortion is so severe that it's probably a safe assumption that market reform in the USSR will result in larger protein meal imports.

Conclusions

The USSR is in the early phase of a significant restructuring of its economic system. The traditional Soviet economic model has reached a developmental impasse, being too costly and inefficient to maintain an adequate degree and quality of growth. The question now is what will replace it. Gorbachev has spoken in favor of a mixed plan-market economy, that would combine the best aspects of a market system and socialism. What this hybrid system might look like remains vague.

The pressing need for efficiency gains in the Soviet economy, and the poor experience of East European countries' attempts to tinker with the traditional Soviet model, indicate the USSR will eventually adopt a market economy. Certain aspects of a market system seem to be in the offing. These include a movement of domestic prices toward world market levels, introduction of meaningful financial discipline at the enterprise level through a significant tightening of the banking and credit system, further relaxation of central control over foreign trade (possibly including some degree of con-

vertibility of the ruble), 2/ and further development of small-scale business and cooperative activity.

What remains further down the road, and in greater doubt, is the extent to which capital and land markets will be developed, the manner in which the state will divest itself of productive assets, the future role of price controls in wholesale and retail markets, and the extent to which the ruble will become convertible. Because of the weak financial situation of Soviet agriculture and the likely social costs of agricultural economic reform, this sector will probably remain insulated from the full impact of reform policies in the initial phases of reform.

Assuming steady progress toward trade liberalization and movement to free markets internally, Soviet agricultural trade will be subjected to significant shocks in coming years. Though unambiguous conclusions are difficult to establish at this point, evidence suggests that the value of total Soviet imports will not increase significantly in the short run (before the economic reform is able to improve the competitiveness of Soviet exports). Whether agriculture can maintain its current high share of total Soviet imports, or even more, increase its share, is open to question.

The process of adjustment will be complicated and involve changes not only in the agricultural sector, but throughout the Soviet economy. With an exchange rate as high as some Western economists are predicting, there is some indication that Soviet agriculture could be competitive on world markets. Market reform is expected to have a positive supply-side impact on agriculture, though the full impact will not be immediately apparent and could be counterbalanced in the short run by higher costs.

Evidence from estimation of CSE's and international comparisons of per capita consumption suggests that introduction of market reforms will have a demand-dampening impact. Because excess demand for food is so large under the USSR's current economic system, this dampening may not result in excess supply at current trade levels.

Some changes in the trading partner structure of Soviet agricultural trade, which are independent of changes in the commodity structure, can be anticipated. This is due to the heretofore special bilateral trade relations with other CMEA countries. In the last year these traditional trade relations have broken down as many of the countries of Eastern Europe move toward world market prices as a basis of trade. Eastern Europe is traditionally an important supplier of meat, vegetables, and fruit to the USSR. It may be the case after economic reform settles out in the region, that Eastern Europe's agricultural trade relations with the USSR will approximate the traditional bilateral levels, but this will depend on a number of factors, not the least of which is future ties between Eastern Europe and the European Community.

Notes

1/ PSE's and CSE's are used as the price wedge, the difference between internal and world prices.

2/ See article by Urban, below.

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China's Agriculture And Trade: Development and Prospects

by
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Abstract: China's agricultural production slowed down in the second half of the 1980's. Agricultural trade will continue to expand but at a much slower rate. The changing political situation in Eastern Europe, together with the Tiananmen Square incidents in June 1989, have slowed foreign investment in China. With greater domestic demand and slowing production growth, the country's agricultural commodity exports should continue to shrink. A gradual increase in grain imports is expected. The U.S. share of China's imports will largely depend upon U.S. price competitiveness in international markets.

Keywords: China, agricultural production, trade, consumption, political unrest, investment, credit.

After expanding rapidly between the late 1970's and mid-1980's, China's agricultural production slowed to a more normal growth rate in the later half of the 1980's. Agricultural trade expansion, which has been closely related to regional or local production and consumption patterns in the last decade, should continue, but at a slower pace. Last year's political incidents had little direct impact on the country's agricultural production. However, the changing political situation in the USSR and Eastern Europe, following China's Tiananmen Square incidents in June 1989, is slowing foreign investment in China, thereby reducing the availability of foreign capital for China's long-term agricultural development. China's recentralized control of certain agricultural activities since the end of 1988 is considered temporary, but most rural reforms are reportedly to continue.

With domestic demand increasing, the country's agricultural commodity exports, particularly feed grains, should continue to shrink. A slow increase in grain imports, mostly wheat, is projected as per capita income and population grow. The country is expected to remain a major net grain importer through the 1990's. The U.S. share of China's grain imports will largely depend upon U.S. price competitiveness in international markets.

Production Growth Has Slowed

China's total agricultural production, excluding village enterprises, grew by about 7.5 percent per year between 1978 and 1984, but slowed to slightly less than 4 percent annually for the second half of the last decade (fig. H-1). In the two decades prior to 1978, in contrast, the average long-term growth rate was about 2.6 percent (3, 4).

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In 1979, China's Government began a series of policy changes and reform programs to revitalize the rural economy. Major agricultural policy changes and programs implemented can be generally classified into three categories; procurement and price, institutional and production, and finance and credit. The Government started in 1979 with a significant increase in agricultural commodity procurement prices. Private plots in poor areas were allowed to expand in 1981, and rural trade markets (previously known as free markets) were resumed for grains, live animals, and livestock products. These programs stimulated farmers' enthusiasm to produce more farm output (7).

The Government also began to phase in the household production responsibility system in the early 1980's. With a determination to reorganize farm production units from production teams to farm households, China's Government started to gradually dismantle the commune system in 1982. Another important policy instituted at the same time, to facilitate agricultural production and to move surplus labor out of farming, was to encourage rural industry development. Farm families responded positively to these changes and

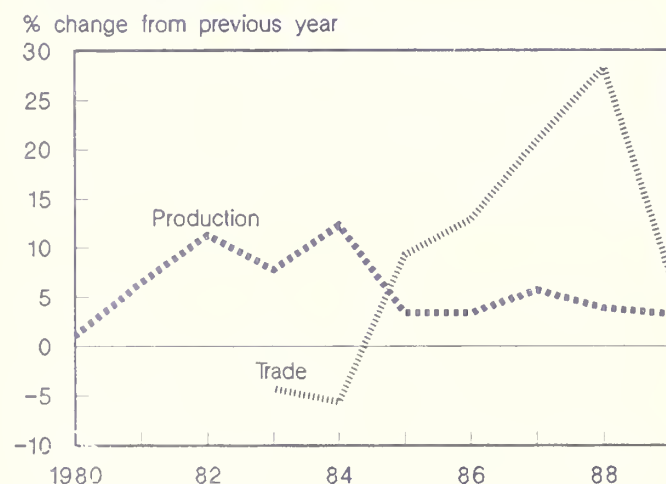
began to plan their production, make economic decisions, and allocate resources to raise output, reduce costs, and maximize income (7). The result was a rapid expansion in production, including grain output (table H-1).

After record harvests in 1984, the Government continued reforms in rural areas, such as reducing the quantity of commodities purchased through the state procurement system, implementing the household procurement contract system, expanding agricultural commodity exports, and restoring the agricultural credit system in rural areas (7, 9). However, the one-time gains from establishing the household production responsibility system in rural areas began to diminish. This, together with decreasing agricultural sector investment and inadequate supplies of inputs, such as chemical fertilizers and pesticides, slowed agricultural production in the past several years. Not until 1989 did grain output barely equal 1984's peak crop (table H-1) (5).

Other reasons cited for the slower growth of overall agricultural production include a decrease in crop areas, bad weather, an irrational price system, and less profitable margins for producers. Farmers and rural household members, therefore, neglected farm production and tried to shift to other, more profitable, production activities, such as fishponds, working in rural industrial enterprises, and establishing private business.

Figure H-1

China's Agricultural Production and Trade Changes



Agricultural Trade Expanded

China's overall trade expanded rapidly, with almost 13-percent annual growth between 1981 and 1988, except for 1982. In general, China's agricultural trade also grew, but more unevenly and at a slightly lower rate, 11.7 percent per year since 1983, the earliest year comparable data were available (fig. H-1). The share of agricultural trade in total trade declined in the first half of the 1980's and then remained constant for the second half, implying that non-agricultural trade, such as textile products and other output, expanded more rapidly (table H-2 and fig. H-2).

Table H-1--Major commodity output in China, 1980-89

Commodity	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989 1/
Million tons										
Rice, unmilled	139.9	144.0	161.6	168.9	178.3	168.6	172.1	174.3	169.1	179.0
Wheat	55.2	59.6	68.4	81.4	87.8	85.8	90.0	85.9	85.4	91.0
Coarse grain	82.4	79.4	81.8	91.6	96.2	82.3	87.0	95.8	94.3	91.3
Oilseeds 2/	9.4	23.6	26.0	27.2	31.1	31.6	30.9	33.7	30.6	29.2
Cotton	2.7	3.0	3.6	4.6	6.3	4.1	3.5	4.2	4.1	3.8
Sugarcane & sugar beets	29.1	36.0	43.6	40.3	47.8	60.5	58.5	55.5	61.9	57.9
Pork	11.3	11.9	12.7	13.2	14.4	16.5	18.0	18.3	20.2	21.3
Beef & mutton	0.7	0.7	0.8	0.9	1.0	1.1	1.2	1.5	1.8	2.0

1/ All preliminary estimates. 2/ Includes soybeans, cottonseed, peanuts, rapeseed, and sunflowerseed.

Sources: (4) and (5).

Agricultural trade has contributed only about 14 to 15 percent of China's total trade value in recent years, compared with over 20 percent in the early 1980's (table H-2). However, with the exception of 1982, China had an agricultural trade surplus, in contrast to deficits for overall trade since 1984. The agricultural trade surplus grew sharply in the mid-1980's, as China decided to export more agricultural commodities when commodity production peaked in 1984. The surplus decreased toward the end of 1980's but remained around \$3 billion in 1989.

China's agricultural commodity exports have grown steadily from the early 1980's (fig. H-3). The Government's decision to lower agricultural imports in the mid-1980's, particularly of wheat, enabled China to increase its agricultural trade surplus rapidly during that period.

On the export side, the country started shipping corn, oilseeds (including soybeans), and cotton to many Pacific Rim countries such as Japan, South Korea, the Philippines, Malaysia, Hong Kong, Singapore, and Indonesia. The decision to

export was made mainly because of infrastructure problems such as lack of transportation, storage, and processing facilities. Also, many local areas had difficulties stockpiling crop surpluses. Rather than stockpile, some areas found it profitable to export their surpluses. However, the expansion of commodity exports has slowed in the last couple of years, because crop production stagnated and domestic demand for feed grains, soybean meals, and cotton grew.

On the import side, China sharply reduced all imports of agricultural commodities after 1984 (fig. H-4). For example, corn and cotton imports were largely eliminated for a number of years, and wheat purchases were reduced to only about 6 million tons in 1985 and 1986, from a previous high of almost 14 million tons. China also began to sell cotton in 1985 and became a major cotton exporter, after being a major importer at the beginning of the 1980's.

The situation with imports, similar to the exporting side, also changed in the last 2 or 3 years due to lower agricultural production. In general, imports of corn, oilseeds, and cotton

Table H-2--China's agricultural trade, 1981-89

Year	Total trade	Annual growth	Agricultural trade						
			Total	Annual growth	Ag trade over total	Exports	Ag exports over total	Imports	Ag imports over total
	\$ Bil	Percent	\$ Bil	Percent	Percent	\$ Bil	Percent	\$ Bil	Percent
1981	44.022	NA	NA	NA	NA	NA	NA	NA	NA
1982	41.606	-5.5	8.842	NA	21.3	3.999	17.9	4.843	25.1
1983	43.616	4.8	8.458	-4.3	19.4	4.552	20.5	3.906	18.3
1984	53.549	22.8	7.986	-5.6	14.9	5.233	20.0	2.753	10.0
1985	69.603	30.0	8.726	9.3	12.5	6.280	23.0	2.446	5.8
1986	73.846	6.1	9.852	12.9	13.3	7.116	23.0	2.737	6.4
1987	82.653	11.9	11.915	20.9	14.4	8.027	20.4	3.888	9.0
1988	102.791	24.4	15.284	28.3	14.9	9.457	19.9	5.828	10.5
1989	111.628	8.6	16.407	7.3	14.7	9.702	18.5	6.705	11.3

Sources: 1981-85 from (3) and 1986-89 estimated from (1).

Figure H-2

China's Agricultural Production Indices, 1980-89

% of 1977-79

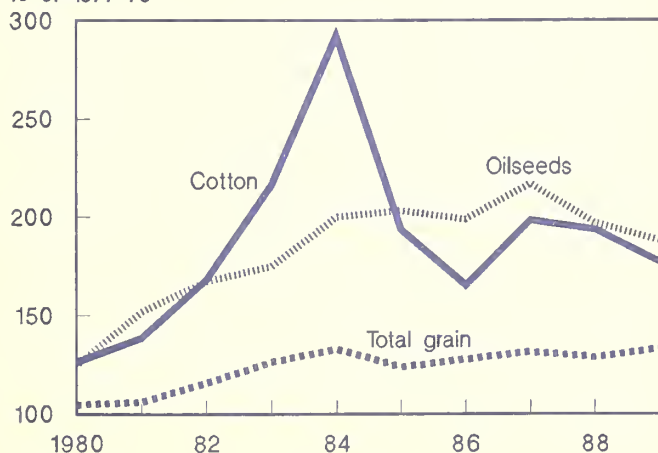


Figure H-3

China's Major Agricultural Exports

Million tons

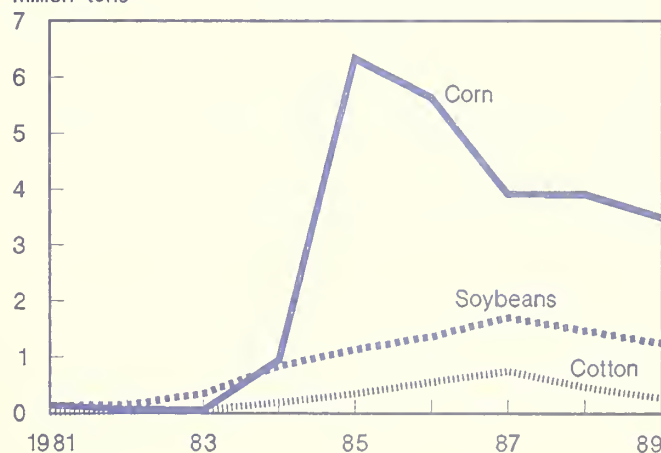
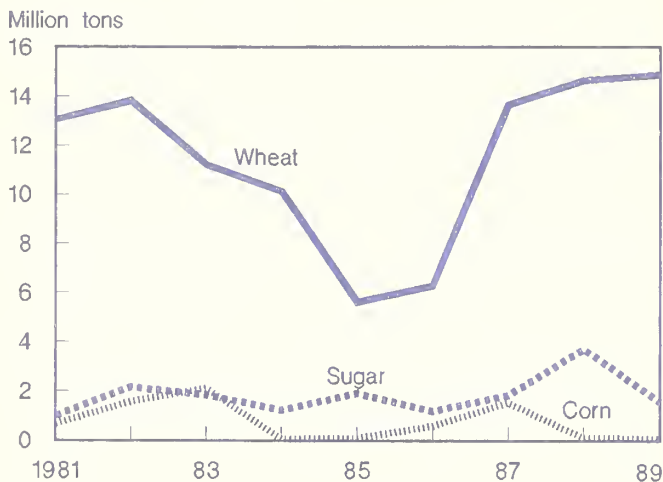


Figure H-4

China's Major Agricultural Imports

have resumed, with cotton imports picking up relatively significantly in 1989. Because of severe shortages, China also sharply increased raw sugar and agricultural chemicals imports, including fertilizer, in the last 2 or 3 years.

Domestic Consumption Climbs But Output Expansion Uncertain

The growth of per capita income in both rural and urban areas is likely to be slower, but will continue to increase in the future, despite last year's political unrest. This income growth, together with population growth, will spur the per capita consumption of agricultural commodities, which has increased markedly in the 1980's. For instance, per capita grain consumption was 198 kilograms in 1958 and 196 kilograms in 1979. But it rose to 254 in 1985 and remained at around 250 for the last 2 or 3 years, although grain supplies have been much tighter in recent years.

Grains consumed by the livestock sector, however, have increased continuously in the last decade. Per capita consumption of livestock products is still low compared with world averages, despite impressive increases in the 1980's. This is also true for vegetable oil, cotton, and sugar consumption.

With expected increases in consumption of agricultural commodities, China faces great challenges to increase its corresponding supplies in the coming decade, and beyond the year 2000. Higher yields, which generated most of the growth in grain production for the last 10 years, will continue to be the sole source of future farm output growth.

Cultivated area has continuously declined in the 1980's because of the increase in nonfarm use, such as expansion of housing, factories, and road construction, and it will continue to decline because there is limited land that can be economically reclaimed. In the last several years, crop sown

areas have been maintained only by expansion of multiple cropping. During the early 1980's, yield increases for wheat, rice, coarse grains, and oilseed crops were rapid, largely because of greater and more efficient use of inputs, improved varieties, better farm management, and more specialization. These changes resulted from the policies and programs implemented since 1979.

The new policies, particularly the household production responsibility system, as previously mentioned, had a largely one-time effect on raising output. Input increases, especially good quality fertilizer and other agricultural chemicals, will be much slower than in the early 1980's. This indicates to China's leaders that farm output will have to continue to increase mainly through better yields, or, for instance, by increased inputs or improved seeds. Recent difficulties in achieving higher yields have led China's policymakers to lower 1990's grain output target from 450 million tons to 412-414 million tons.

Production Not Affected by Political Unrest But Price and Land Contract Systems Need Reform

China's agricultural production was not affected by the political unrest in June 1989. China's agricultural production has been up, and 1989's grain output slightly surpassed 1984's peak crop. However, foreign investment in China's agriculture was reduced because of the unrest, and has only gradually resumed in the last several months. Foreign capital and loans to China in recent months appear to have been granted more slowly than previously thought because of the political and economic reforms taking place in Eastern Europe and the USSR, although the World Bank resumed normal lending to China in early 1990.

It appears that foreign investors are waiting to see if it is more profitable and more secure to invest in Eastern European countries than in China. This may affect the availability of foreign loans for improving China's rural infrastructure development or crop production, particularly in the long run. Capital shortages in China could result if the delays are prolonged.

China's leaders continue to face the need to reform the rural economy. Austerity programs imposed by the Government at the end of 1988 to adjust the entire economy may work in the short run, but will not solve farming problems for the long run. Using administrative measures to direct farming, for example, forcing farmers to plant grain crops or engage in certain other production activities, recentralizing fertilizer distribution, monopolizing cotton procurement, and severely cutting loans and credits granted to rural industrial development may be effective temporarily, but reestablishment of the command economy system will not help to sustain agricultural development or to continue improvements in China's agriculture.

Currently, China's agricultural production faces two pressing issues: improvement of price and land contract systems. Without a rational price system, China's crop production, particularly grains, will not be profitable, output increases will be difficult to achieve, allocation of resources will be inefficient, and the composition of crop and livestock production will be irrational.

China's planners must increase investment in agricultural infrastructure, such as irrigation and drainage, transportation, and storage. Since the household responsibility system was implemented, Government investment, including national and local investment in the farming sector, has fallen dramatically.

The Central Government's investment in agricultural capital construction as a share of the total fell from 11.1 percent in 1979 to only 3.0 percent in 1988. During the same period, individual households' investments were also very low. Farmers have felt too insecure to invest in the land they contracted because the legal system does not guarantee that producers may continue to farm the same piece of land.

Without a stable legal system to protect farmers' land use, individual investment in farmland will not occur. Continued lack of household investment for land improvement and reduced Government investment in capital construction, such as irrigation and drainage, will constrain future farm growth.

Other problems in the agricultural sector are inefficient marketing and information systems. The old Government procurement system cannot deal efficiently with the rapid growth of farm products and the rising importance of consumer demand. The grain rationing system provides low-priced grain, which not only encourages waste but also deteriorates the pricing system of the entire grain market. Unless the system changes, producer incentives will be diminished, consumer dissatisfaction will grow, and various subsidies will strain the Government's budget.

Outlook for the 1990's

Agricultural production, excluding rural industrial enterprises, is expected to grow an average of 3 to 3.5 percent for the first 5 years, roughly the same rate as in the last 2 years, and then about 3 percent for the rest of the decade. Feed grain use should gradually level off in the 1990's, because of Government plans to emphasize more production of animals and products which have better grain convertibility. Industrial use of grain, however, will increase. Production and trade prospects are summarized as follows:

Wheat—China's demand for wheat will continue to grow as income and population increase. This, coupled with slower production gains, will maintain import levels as high as in the last two years (6). Imports could even approach 20 mil-

lion tons at the end of this decade, provided that the current foreign exchange situation does not worsen. Otherwise, the Government will regulate wheat consumption, for instance, to raise domestic procurement, lower wheat rationing, or slow import expansion.

The United States has recently regained the largest share of China's wheat imports, largely because of Export Enhancement Program (EEP) subsidies. Future exports to China will also depend on the price competitiveness of U.S. wheat in international markets (fig. H-5 and table H-3).

Rice—Rice output peaked in 1989, slightly higher than the previous 1984 record. China's rice consumption is slowing, and in urban areas even shows some decline. Farmers are still feeding large quantities of rice to livestock. If China's transportation system is improved, large rice imports, as in 1989, will not be needed, and the country may export rice to international markets.

Coarse grains—Coarse grain output peaked in 1984 and has fluctuated since then. Human consumption of coarse grains declined sharply in recent years as consumers have shifted to wheat, rice, vegetables, and meat. In contrast, the livestock sector has demanded increasing amounts of coarse grains, particularly corn, and pressured the Government in the last 2 or 3 years to reduce corn exports to Pacific Rim markets. Domestic corn demand increased so rapidly that now the Government leaders encourage farmers to raise more animals with better feed convertibility. Therefore, although corn exports may well continue, they are expected to diminish in the next few years.

China also imported corn in the last several years, mainly because of a poor internal transportation system. Until the system is improved, particularly outside of the Northeast Region where corn is a major surplus commodity, China may continue to import some corn into the southern prov-

Figure H-5
U.S.-China Agricultural Trade

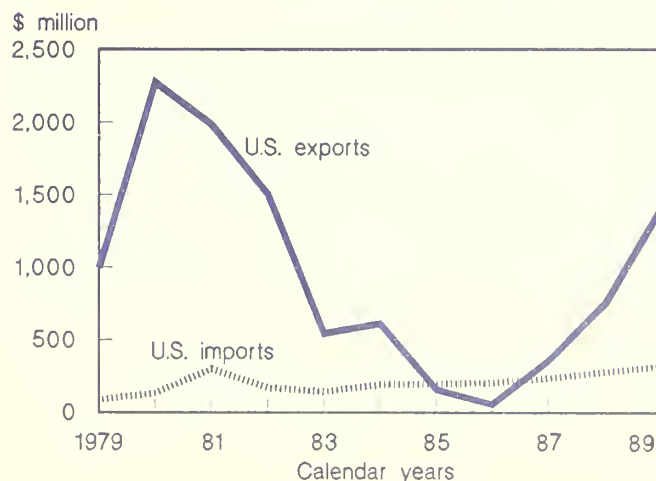


Table H-3--U.S. agricultural exports to China

Year 1/	Wheat	Corn	Soybeans	Cotton	Total value
	----- 1,000 tons -----				\$ million
1979/80	4,036	1,788	810	514	1,937
1980/81	7,693	725	472	254	2,118
1981/82	8,221	1,117	370	186	1,819
1982/83	1,921	2,161	0	2	546
1983/84	4,579	0	0	3	692
1984/85	1,343	0	0	1	239
1985/86	142	0	187	0	83
1986/87	898	1,090	250	1	235
1987/88	5,826	217	179	0	613
1988/89	8,323	0	0	186	1,494

1/ Year ending September 30.

Source: (8).

inces. A large quantity of corn imports is unlikely, however, because foreign exchange reserves are not expected to grow significantly, so policymakers will not be inclined to import large amounts of feed grains.

Soybean and soybean products—Soybean production in China has been very slow and unstable in recent years. Soybean meal is gradually being integrated into China's feed manufacturing system. Soybean products have been in high demand in recent years because of rising incomes and health concerns. Total demand for soybeans and soybean products will continue to increase. Soybean and soybean meal exports have expanded rapidly, but started to decline last year. Exports are expected to gradually decrease but not entirely disappear, because joint ventures require soybean meal to be exported to earn foreign exchange to pay back loans for processing plant construction. Food bean exports to Japan will continue.

Cotton—In 1983, China's supplies of cotton were so far above demand that the country not only started exporting cotton, in 1984, but also began to restrict output by lowering cotton procurement prices. However, an unexpected surge in domestic demand and vigorous export efforts have led the country to boost output again. Although China still continues to export cotton, it also purchases some cotton on international markets. China's cotton exports will gradually decline. Basically, China will try to become a cotton self-sufficient country.

Consumption of other agricultural commodities or processed products will continue to rise due to increased income. Consumer tastes have diversified significantly, and demand for items such as beer and soft drinks has grown very rapidly. The food processing industry is expected to expand rapidly to meet varied tastes as well as for export to help earn foreign exchange. The Government will continue to seek

advanced technology and modernized equipment to improve food processing and packaging.

Overall, earlier dramatic growth of China's agricultural production and exports has obviously declined, but a country as big as China will continue to play an important role in world agricultural markets. China's potential as an agricultural exporter, particularly of major commodities, is gradually diminishing, mainly because of slowing growth of agricultural production and increasing domestic demand. But the country will continue to be a significant player in international commodity trade as it enters or withdraws from world markets.

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The Changing Structure of Japanese Agricultural Trade

by
William Coyle*

Abstract: The structure of Japanese agricultural imports has changed significantly in the last two decades. Value-added imports are now almost as important as bulk commodity imports. The shift toward value-added imports has been induced by reduction in tariffs and other trade barriers, the rising value of the yen, rising consumer incomes, and changing comparative advantage in some industries. Continuation of the shift will depend on further trade policy changes and other factors affecting the competitiveness of Japan's agribusiness sector.

Keywords: Japan, agricultural trade, value-added trade.

The rapid pace of political and economic reforms in the USSR and Eastern Europe has captured the world's attention. Japan, by contrast, often appears reluctant to change because of persistent and large trade surpluses, an inhospitable attitude about foreign investment and imports, and a political system dominated for 35 years by one party. Changes that do occur in Japan are slow and incremental, and sometimes go unnoticed.

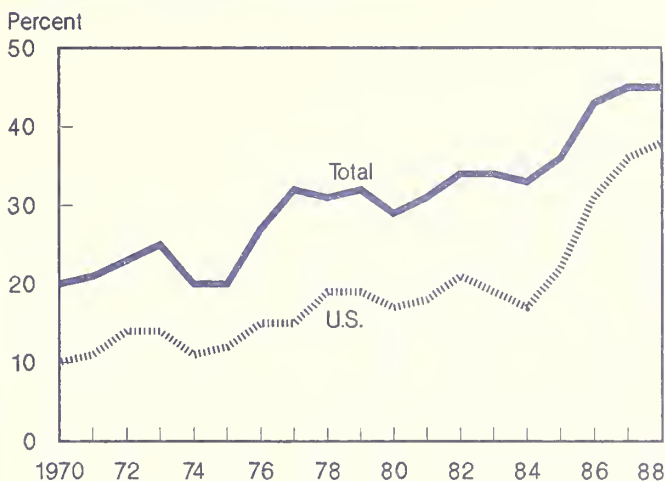
Lack of change is also a common perception about Japan's agriculture and agricultural trade. Its agricultural sector consists of many small-scale, part-time operators and is the most heavily assisted among developed countries. The level of assistance has not changed much in recent years. Its farm policy, oriented toward maximizing self-sufficiency in rice, is born out of an historical concern for food security. This is not surprising for a small island nation with limited resources, a large population, and experience of food shortages during and immediately after World War II.

Nevertheless, the volume and composition of Japan's agricultural imports have gradually changed. Import volumes rose despite protection levels that grew to high levels over the past three decades. Limited land resources and dietary changes resulting from higher consumer income led to declines in agricultural self-sufficiency—from about 75 percent in 1960 to about 45 percent today—making Japan ever more dependent on imports. Imports have been, and still are, predominantly bulk commodities like coarse grain, soybeans, cotton, and tobacco. This has been the case because border measures are most restrictive for value-added commodities, except for food grains (rice, wheat, and barley).

But the composition of Japanese agricultural imports has also changed, gradually shifting to more value-added products. This change accelerated significantly after 1985 as a result of tariff reductions, deregulation of foreign cigarette imports, the market-liberalizing beef and citrus agreements in 1984 and 1988, the GATT-12 agreement, and a 73-percent appreciation of the yen from 239 yen per U.S. dollar in 1985, to 138 in 1989.

Value-added commodities rose from 20 percent of total agricultural imports in 1970 to 45 percent, or \$12 billion, in 1988 (fig. I-1). Livestock and tobacco products, fruits and vegetable products, cereal preparations, and wine, beer, and cigarettes rose in relative importance, while tropical products declined (fig. I-2).

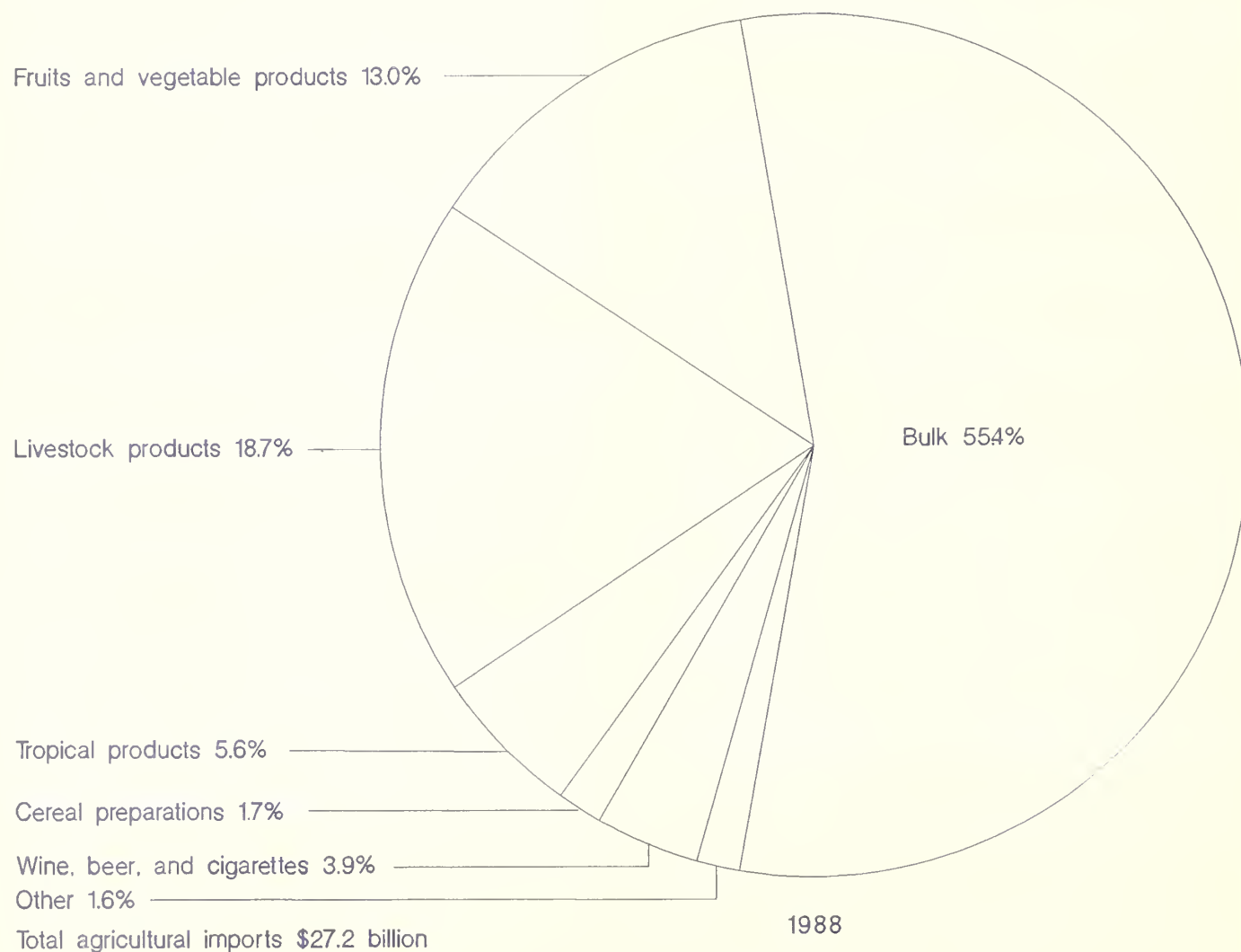
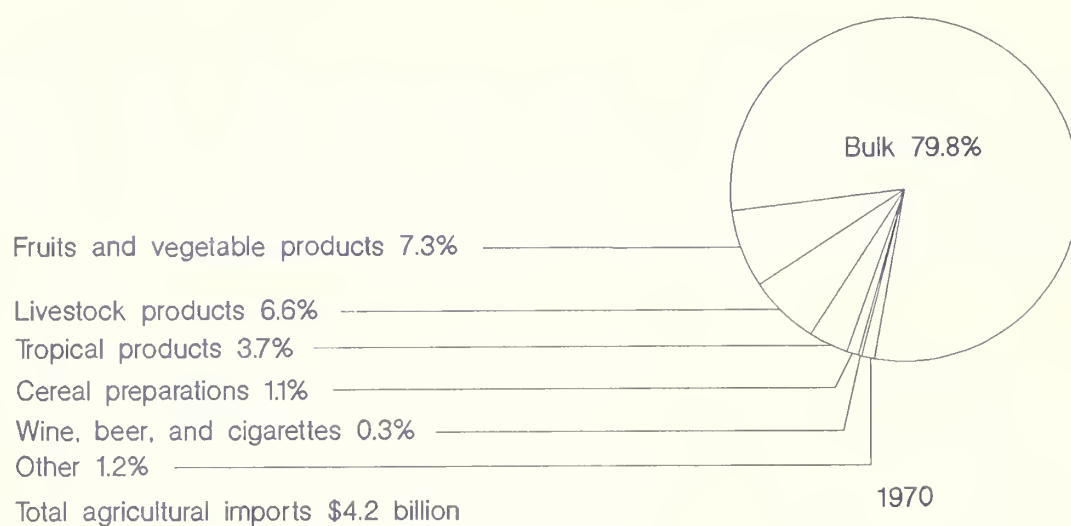
Figure I-1
Share of Value-added Commodities in Japanese Agricultural Imports



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Figure 1- 2

Changing Structure of Japanese Agricultural Imports



The changing composition of Japanese farm imports is noteworthy to the United States and other exporting nations in the Pacific and elsewhere for two reasons: (1) the sheer size of the Japanese market—the world's largest single net importer of agricultural products—makes changes there very important to the future well-being of exporters or potential exporters; and (2) the shift to value-added imports means greater economic activity associated with the increased role for processing and marketing.

These changes in trade composition or structure can be illustrated by some examples.

More Meat, Less Grain Imports

Japanese meat imports rose throughout the 1980's while growth in feed grain imports slowed, finally stalling after 1987. On a grain equivalent basis, Japanese meat imports were about 12 percent of total grain imports in 1980, rising to 25 percent in 1989, as may be seen in figure I-3, in which meat imports have been converted to grain equivalents and added to feed grain imports.

The most important policy change leading to this shift in imports was expansion of beef import quotas under agreements in 1978 and 1984. Beef imports will continue to grow with expansion and planned elimination of quotas in 1991 under the 1988 agreement. Tariffs for beef will be raised from 25 percent to 70 percent in 1991, and then reduced to 50 percent by 1993. Tariffs and deficiency payments for producers of feeders will provide some support to Japan's beef

industry, but at a lower level than during the era of import quotas.

Other import-promoting measures included lowering tariffs for imports of beef offals in 1984 from 25 to 15 percent and lowering tariffs on poultry meat from 20 percent in 1980 to about 12 percent by the end of the decade. Measures taken as a result of the GATT-12 case settled in 1988 liberalized imports of processed cheese and preserved and prepared beef. Finally, freezing and lowering support prices for beef, pork, and manufacturing milk since 1983 sent a signal to producers that future Government support was no longer guaranteed.

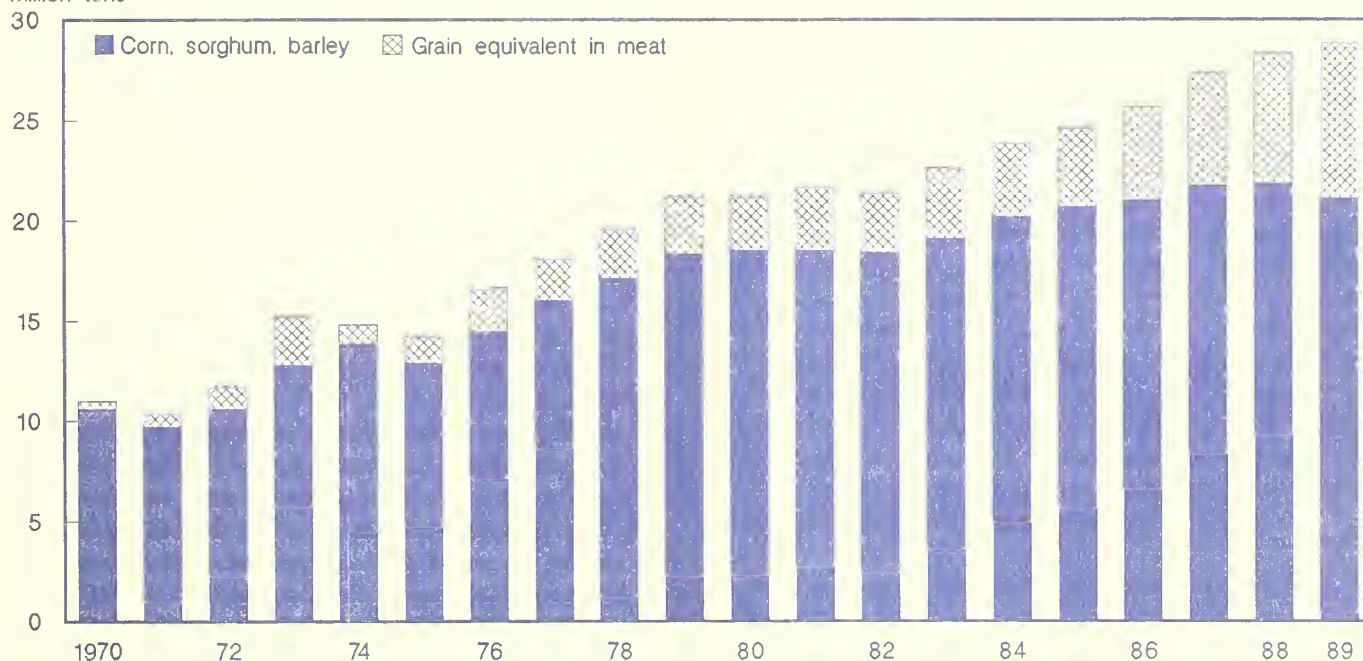
The shift to more meat and less grain imports is significant because of the relative importance of livestock in Japan's agriculture and trade. Japan's livestock sector is second only to rice in terms of gross farm income generated. It has grown in importance as a result of Westernization of the diet. This has resulted from rising consumer incomes and agricultural policies designed to promote domestic production by high levels of protection for livestock products and lower levels for feedstuffs. Growth in Japan's livestock industry has been absolutely dependent on imported grains, amounting to about 22 million tons in 1989.

Adjustment to these policy changes is incomplete. The Japanese beef industry has maintained production, but the 1988 agreement will not be fully implemented until 1993. Strong

Figure I-3

Japanese Grain Imports

Million tons



1989 estimated.

product and feeder prices have lessened doubts about the potential of the industry to survive the 1988 agreement.

Moves to consolidate operations and increase productivity have been reported, but are difficult to assess in the aggregate. Some Japanese are investing in lower cost, more competitive livestock operations offshore to position themselves for future opportunities in the Japanese market. This phenomenon has been most noticeable in the beef market. Japanese investors have bought a number of U.S. cattle ranches, feedlots, and packing facilities. Similar purchases are reported in Australia and New Zealand.

Japan's poultry sector is more competitive but it also has been forced to adjust, unable to compete with imports and take advantage of increased consumption. Lower tariffs and anticompetitive policies in Japan's feed sector have squeezed industry profits.

Feed sector policies make it difficult for the poultry industry to fully integrate operations and to keep feed costs low. The Government's power of licensure 1/ limits the entry of new feed mills and, thus, the level of competition in feed production. (Regulation in this sector is designed to protect starch producers by preventing corn destined for animal feed from leaking into the starch sector.)

The feed sector is also protected by a 15-percent duty on mixed feed imports. The Feed Price Stabilization Fund was set up in 1975. It stabilizes feed prices by taxing participating livestock producers when feed grain prices decline and by subsidizing them when prices rise. This is inconsistent with a potentially efficient industry becoming more and more exposed to import competition. Some Japanese capital has sought more favorable returns in the poultry industries of countries like Thailand, Indonesia, and Mexico.

The outlook for the continuation of the meat-for-grain trend in Japanese imports is favorable. Japan's beef industry will continue to be plagued by inefficiencies in the traditional small-scale Wagyu sector and the dependence on calves and culls from the dairy herd (whose inventory is limited by growth in demand for dairy products which is likely to be slower than growth in demand for beef).

Other limiting factors are relatively high feed costs and small pasture area. As beef market liberalization proceeds, countries with plentiful feed supplies will increase their competitive advantage over Japan in beef production. The inescapable reality is that ruminants are efficient converters of low-grade roughage to high-grade protein; countries with plentiful supplies of roughage will have a competitive advantage over Japan.

The outlook for domestic expansion in pork and poultry production is less certain. Nevertheless, even these more com-

petitive industries face rising costs because of water pollution and waste disposal problems. Reform of feed sector policies that could reduce feed costs, on the other hand, is likely because of pressure from livestock producers. It is conceivable that Japanese poultry production could become competitive in foreign markets if feed costs were lower.

The more likely scenario for the future is a continuation of larger Japanese meat relative to grain imports, perhaps slowing some as Japanese consumers reach levels of meat and fish consumption comparable with other developed nations. The sourcing of Japan's meat imports is less certain and may be influenced by Japanese investment in fully or partially owned livestock operations in other countries.

More Cigarettes, Less Leaf Tobacco

The value of Japanese cigarette imports in 1989 was \$950 million, exceeding the value of leaf tobacco imports by more than 2 to 1. In 1986, cigarette imports were only \$180 million compared with \$360 million for leaf imports (fig. I-4). The causes of this sudden change were tariff reductions on imported tobacco products and market deregulation after April 1987. Foreign cigarettes now account for about 15 percent of the Japanese market, compared with only 1-2 percent 10 years ago.

While leaf imports are expected to decline in the long run along with rising cigarette imports, leaf imports have remained fairly steady since 1987. So far, most of the adjustment has occurred in domestic tobacco production, declining about one-third since 1987. Government payments have helped ease producer adjustment, and the sole manufacturer of tobacco products in Japan plans to diversify into other business areas to cope with declining cigarette sales.

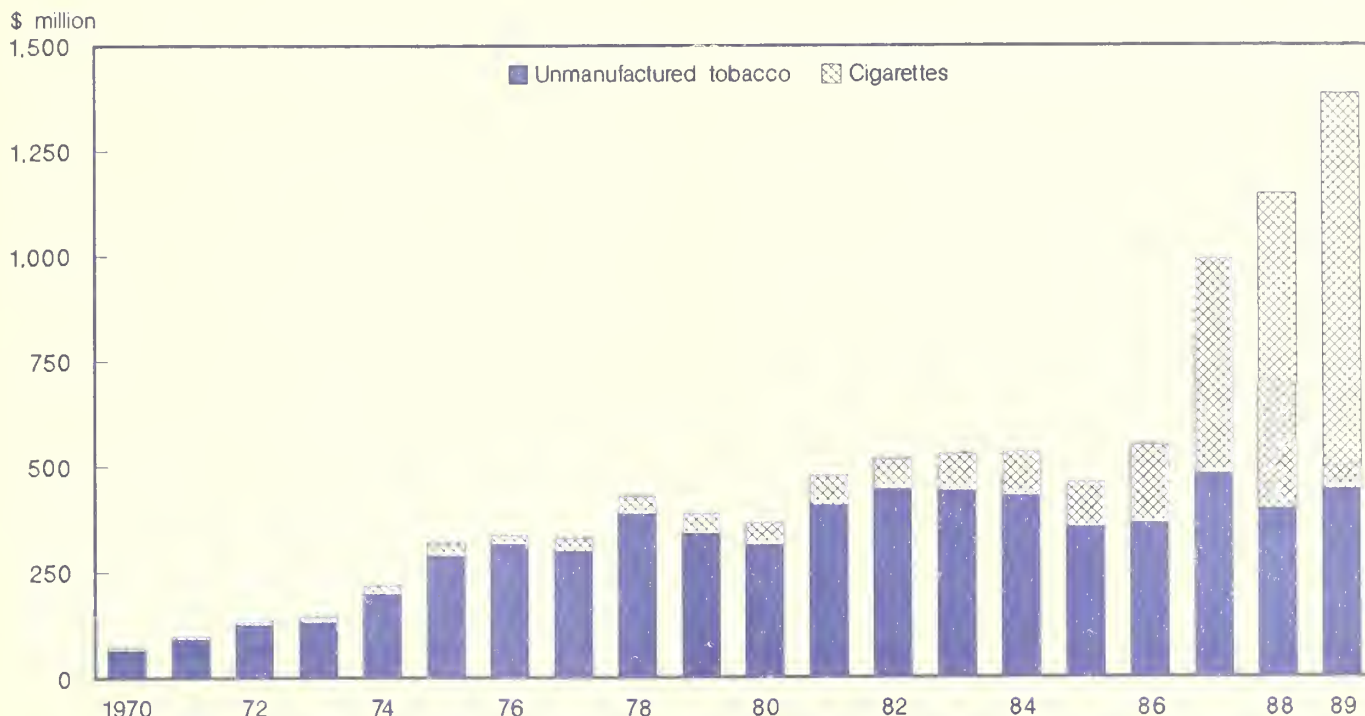
Pressures to reform Japanese tobacco policy go back more than 10 years. The Japanese market was key to the marketing strategy of U.S. and other foreign tobacco firms because of its size, second only to the United States. Even though Japanese consumption was declining, low import penetration meant that the market potential for low-priced foreign cigarettes was promising if restrictive barriers could be reduced. Imports were controlled by the Japan Tobacco and Salt Corporation to protect inefficient Japanese tobacco producers.

In 1985, after years of negotiations, this public monopoly was privatized, renamed the Japan Tobacco Institute, and stripped of its powers to regulate imports. Tariffs were reduced. The final hurdle was overcome in 1987 when pricing and distribution of foreign tobacco products were deregulated, and taxes on domestic and foreign products were harmonized.

The future for Japanese cigarette imports depends on the success of foreign tobacco companies in capturing a larger and

Figure I-4

Japanese Imports of Cigarettes and Unmanufactured Tobacco



larger share of the declining Japanese market from the Japan Tobacco Institute. Competitiveness of Japanese cigarettes will depend on quality and price. This is hampered by requirements to use high-cost domestic leaf.

More Finished Textile Products, Less Raw Fibers

The dramatic increase of Japan's textile imports (yarn, fabrics, and finished goods) in the last two decades, compared with raw fibers, reflects a growing comparative disadvantage for Japan's spinning, weaving, knitting, and apparel industries (fig. I-5). Wages in Japan have been rising faster than in South Korea, Taiwan, Hong Kong, and the United States. Wages are critical to the competitiveness of a nation's clothing industry, the most labor-intensive stage in the textile sector. Appreciation of the yen, particularly after 1985, pushed up even more relative labor costs in Japan. Imports of some intermediate and finished textile products are now cheaper than those manufactured locally from imported raw cotton.

Japanese firms are adjusting by reducing domestic production and transferring employees to nontextile divisions or relocating them to affiliates overseas, and by investing in other parts of the world where production costs are lower. Some companies are diversifying into nontextile areas like plastics, chemicals, and pharmaceuticals. Some Japanese investment has been attracted to the United States and is quite apart from the Japanese market. For example, one Japanese firm in the United States manufactures unfinished

goods, then exports them to Mexico or Puerto Rico where they are manufactured into garments at lower cost, and shipped back to the United States.

Japan's imports of cotton fabric, yarn, and clothing will likely continue unless labor costs are reduced. Critical to raising labor productivity will be technological innovations that increase automation of the clothing industry. However, no breakthrough is expected before the turn of the century.

More Pasta, Less Wheat

Japanese imports of cereal preparations totaled more than \$400 million in 1988 and represented a rising share relative to wheat imports (fig. I-6). This growth in trade is due to strict controls on food grain imports and the appreciation of the yen, particularly after 1985.

The Japanese Food Agency controls the purchase and marketing of domestic and imported wheat, rice, and barley. The quotas on wheat and barley, and the near ban on rice imports, protect small-scale, inefficient producers from cheaper imported food grains. Processed products made from these grains are protected by tariffs, which in some cases have been reduced in the last decade. The rising value of the yen has made the price of these products, even with tariff protection, more competitive with domestically produced products (fig. I-7).

Figure I-5

Japanese Imports of Fibers and Textiles

\$ billion

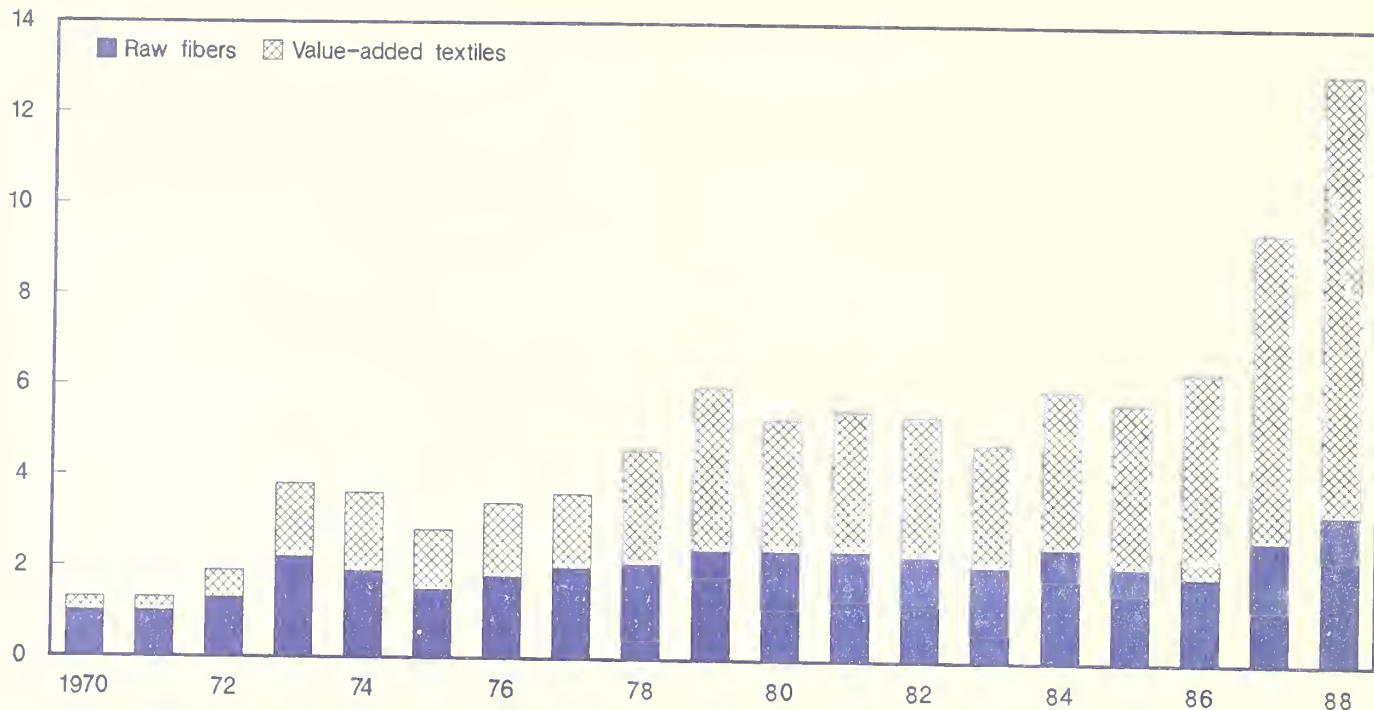


Figure I-6

Japanese Wheat and Noodle Imports

% of 1980

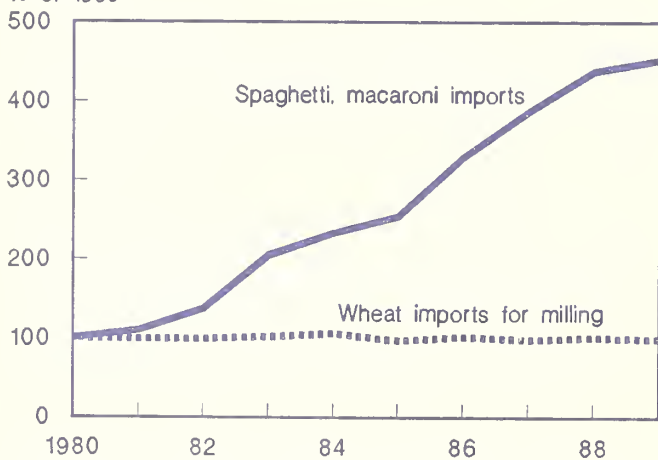
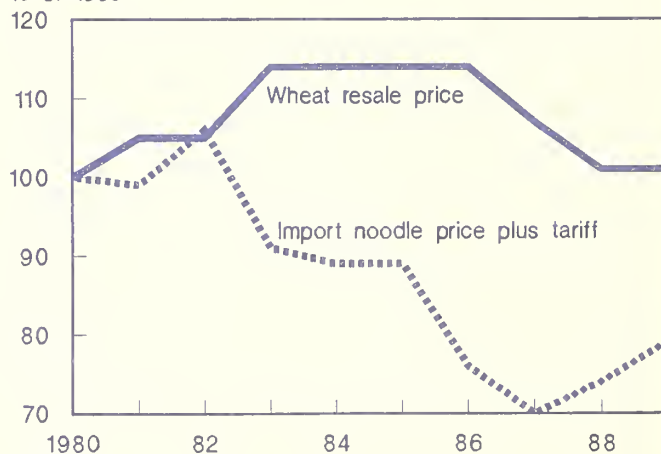


Figure I-7

Japanese Wheat and Noodle Prices

% of 1980



The future of this phenomenon depends very much on future reform in Japanese rice policy, which is under discussion in the Uruguay Round of GATT negotiations. If Japanese rice and wheat imports were liberalized, the cost of producing cereal products in Japan would decline to the extent that domestic raw materials costs declined. While the outcome of the GATT negotiations is uncertain, indications are that reform in rice policy will eventually take place because of its high cost to taxpayers and consumers and because of declining political support. Liberalization of Japan's food grain sector would eliminate the distortions that have prompted increased imports of processed cereal products. This is one case where liberalization would likely increase imports of bulk grains and reduce imports of cereal preparations.

Conclusions

The shift from bulk commodities to a larger value-added component in Japanese agricultural imports has happened gradually over the past 20 years. Key factors have been:

- removal of trade-restricting border measures;
- the appreciation of the yen and growth in income;
- changing comparative advantage for some industries; and
- distortions in related raw material markets.

Japanese industry has adjusted by:

- reducing production;
- diversifying into other more competitive industries; and
- investing in lower-cost operations in other countries.

The outlook for Japanese value-added agricultural imports will depend on: (1) further liberalization of Japan's agricultural market (reducing tariffs, eliminating the remaining import quotas including those for rice); (2) the value of the yen and economic growth; and (3) the competitiveness of the food processing industry.

Growth in Japanese imports of value-added agricultural commodities underscores a number of points about world agricultural trade. First, the value-added component is more diverse and more complicated than the bulk component. Assessing conditions in this diverse area of trade is difficult.

Second, as markets become more open and intertwined through trade and foreign investment, a country's competitiveness in agricultural trade has less to do with comparative advantage in producing the raw material and more to do with that in processing and marketing. The extent to which the value-added component of agricultural trade grows depends on whether raw materials are processed near the point of production or near the point of consumption. In the Japanese cases examined, production of cigarettes and cereal products, after liberalization of the food grain market, could increase, thus displacing imports. All stages of textile production have, to a greater or lesser extent, already shifted away from the point of consumption in Japan because of rising labor costs. Beef and, to a lesser extent, poultry production are doing the same because of high feed costs.

Notes

1/ Since October 1989, the Japanese Ministry of Agriculture, Forestry and Fisheries is no longer required to make recommendations about granting licenses.

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Developing Countries: Changing Closed Systems to Open Ones

by

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Abstract: Analyses of the comparative economic performance of developing countries show that their rate of economic growth and degree of government management of the economy are inversely related.

Keywords: Developing countries, economic growth, open economies, closed economies, import substitution, free trade.

Economists have long debated whether there is a positive relationship between trade and growth, and so have politicians. Policymakers' and their advisors' beliefs about trade's effects on growth can determine a country's trade policies and its economic performance. The debate between free trade and protection was central to the politics of European and North American countries in the past century.

The last major outburst of protectionism among industrialized countries was in response to the Depression of the 1930's. After World War II, the industrialized nations agreed to restrain their domestic protectionist tendencies through international agreements. There was, and still is, a strong belief that free trade leads to greater economic integration, prosperity and peace, and that protectionism leads to stagnation, loss of trade, and military conflict.

Although free trade is viewed as promoting growth among industrialized economies, many economists believe developing economies to be fundamentally different from industrialized economies, and some believe that free trade might actually be a harmful policy.

Partly because of the agricultural depression of the 1930's, many economists thought demand for traditional developing-country exports (primary agricultural and extractive products) would fail to keep pace with supply, and their prices would fall relative to those of developed-country exports. Because primary products were assumed to be the only products developing countries were capable of exporting, many governments and economic advisors concluded that the only viable policy for long-term growth was one of import-substituting industrialization.

Import-substituting industrialization is a strategy that relies on import restrictions to conserve foreign exchange and to protect "infant" industries. The strategy became very popular in the 1950's in India and among Latin American governments, many of whom saw import substitution as a way to lessen their economic dependence on the United States. When many African states gained political independence in

the 1960's, it was believed import-substituting industrialization would further their economic independence from Europe. So they invested in steel and capital goods industries, activities economically inappropriate to their resource endowments.

India and South Korea illustrate the consequences of choosing between inward- and outward-oriented policies. Both had about the same per capita income in 1961, but by 1987 South Korea's per capita income was over four times as great as India's.

The governments of India and South Korea have both taken active roles in managing their economies, favoring selected industries at the expense of others. While India looked to the inward-oriented industrialization of the USSR for its five-year development plans, South Korea pursued an outward-oriented development approach, encouraging external trade. South Korea's surge of growth began in the mid-1960's when it first lowered levels of domestic protection.

Learning by Doing

One key to the success of such countries as Taiwan, Hong Kong, Singapore, South Korea, Malaysia, and Thailand has been their willingness to compete directly with industrialized countries. They successfully put their most abundant resource, relatively unskilled labor, to productive use—specializing first in the production of goods requiring relatively large amounts of unskilled labor. As their labor forces became more skilled, they shifted to goods and services requiring skilled labor. Through engaging in trade and learning by doing, these economies shifted from being exporters of cheap gadgets and garments to being world leaders in such fields as shipbuilding, civil engineering, and consumer electronics.

Furthermore, in contrast to most developing nations, these economies have also had a relatively open door to foreign capital, in addition to maintaining relatively open markets for products. Direct foreign investment and foreign joint ventures have been important means of transferring capital, skills, and technology necessary for industrialization. Perhaps most important of all, they found that participation of

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foreign capital brings with it marketing channels to the consumer and industrial markets of the developed countries. Industrial development can, in the light of these examples, be taken as inseparable from integration with the industrialized economies.

Impact of Free Trade On Economic Growth

The development process involves a transformation of a country's resources and institutions. People become healthier and better educated, and domestic markets become larger and better organized. In turn, a more productive labor force and a more efficient market lead to changes in the sectoral composition of production and trade.

While it is clear that the composition of a country's trade changes in the process of economic development, it is less clear that free trade stimulates domestic economic growth in developing countries. Part of the difficulty in addressing this question is that government intervention in international trade is so pervasive in developing countries. What a country exports or imports is often as much the direct result of government policies as it is of underlying demand and the output of households and firms.

Just because a country is export-oriented does not necessarily mean that it is following a policy of free trade. South Korea, for example has had an outward-oriented trade policy since the mid-1960's. In the mid-1970's, Korean trade policy became "too export oriented" in the opinion of most economic analysts. The Government actively encouraged investment in capital-intensive industries. However, these investments were not appropriate for Korea's resources and, consequently, did not perform as well as expected.

For a few years in the late 1970's, South Korea found itself in a precarious financial position. Hong Kong, Singapore, and Taiwan, which maintained relatively free trade policies, grew faster than South Korea during this period. South Korea recovered, but the policy distortions clearly reduced its realized growth rate, however impressive, below its potential.

Edwards has devised a measure that separates the inward or outward orientation of a country's trade policy from the degree of government intervention in international trade. In a study of 30 developing countries (4), he finds that developing countries with lower degrees of trade intervention grew more rapidly than countries with high levels of intervention. This implies that a movement toward less intervention, regardless of its bias, will tend to enhance growth prospects, while increased intervention tends to impede growth.

Economic Growth and Domestic Institutions

The "rules of the game" enforced by a country's government seem, therefore, to be an important determinant of its economic performance. The extent of freedom allowed and the

degree of state control exercised by a government can be identified in three dimensions—political, civil, and economic.

An open political system allows individuals free entry into politics and the legal means for citizens to remove incumbents from office; a closed system restricts leadership to an uncontested elite. Civil liberties range from absolute protection of individuals' liberties to absolute priority for the state. Economic liberties range from *laissez-faire* systems with no government role in the economy, other than enforcement of contracts, to centrally planned command systems (12).

Table J-1 shows the observed influence of each of these dimensions on the rate of economic growth of 115 countries in 1960-1980. Countries which adhere to open politics, civil liberties, and market-oriented economies have dramatically higher rates of growth than closed, statist, centrally planned regimes. The combined effect of all three dimensions leads, on average, to a threefold increase in average annual per capita growth.

The unequal rates of growth among nations can be, in part, attributed to inequality of income and opportunity within nations. Income distribution and ethnic composition are important determinants of a country's governing institutions, its economic policies, and its economic performance. The data show that greater homogeneity of the population is associated with higher economic growth and lower income inequality, while greater inequality is associated with lower growth.

A high level of income inequality is likely to pit the "haves" against the "have-nots:" demands by the poor for a redistribution of wealth are countered by demands of the rich to maintain the status quo. If the state cannot manage this conflict, political behavior can degenerate into a zero-sum game in which all citizens take defensive postures and are hesitant to make long-term commitments. Investment and growth wane.

Table J-1--Per capita income growth rates, 1960-80, for different institution structures

Indicator	(a)	(b)	Ratio 1/
Political system	Open 2.53	Closed 1.41	79
Legal priority	Individual 2.75	State 1.23	123
Allocation	Market 2.76	Command 1.10	151
Combined effect	2.73	0.91	200
Combined effect on efficiency of resource utilization 2/	.78	.31	152

1/ Ratio = [(a/b) - 1] * 100. 2/ Economies operating on the efficiency frontier obtain a value of 1, in essence a perfect score.

Redistribution struggles are more likely to emerge the greater the ethnic heterogeneity in a country, as the lines of social cleavage are most likely to form along internal ethnic and linguistic boundaries. On the other hand, the risk of redistributive conflict is considerably reduced in relatively homogeneous societies.

A legitimate political order is an important ingredient in economic growth, but its creation is a difficult undertaking. Most developed nations are the product of several centuries of state-building (13). In contrast, the governments of most contemporary developing countries are relatively new and are faced with the task of creating national unity as well as establishing their legitimacy among the populace.

The difficult process of state building is compounded in many countries by a colonial inheritance of arbitrary borders.

This is particularly so in Sub-Saharan Africa, where most nations gained independence between 1957 and 1974 and where today's borders are relics of European balance-of-power negotiations of the last century. Sub-Saharan Africa was parceled out among the European powers at the 1884 Berlin Conference; at Versailles in 1919, the Austro-Hungarian Empire was partitioned into Czechoslovakia, Hungary, Romania, and the Balkans; at the 1923 Lausanne Conference the non-Turkish domains of the former Ottoman

Empire were partitioned; and in 1947 the British partition of its South Asian possessions took place.

In all cases, borders split ethnic groups between countries, forced heterogeneous populations under one rule. This situation has resulted in a high and persistent incidence of ethnic or communal conflict.

Information on income distribution for several developing countries is presented in table J-2 which shows the share of national income received by the poorest 20 percent of the population, the share received by the richest 20 percent, and the ratio of these two values: rich divided by poor. In Ecuador, this ratio indicates that the richest fifth of the population has an income 40 times that of the poorest fifth. 1/

Using this ratio as an indicator of relative inequality, some startling differences in regional inequality emerge. Latin America, by this indicator, has "three times" the inequality of the nations of Dynamic East Asia and China. The nations of South and Southeast Asia occupy a middle ground, while the two African nations for which data are available reveal higher inequality than the Latin American average.

An index of ethnic and linguistic homogeneity is also shown in table J-2. The higher the index value, the more homogeneous the population.

Table J-2--Income distribution of selected countries by region

Country and region	Low 20 percent (a)	High 20 percent (b)	Ratio (b)/(a)	Ethnic homogeneity
Latin America:				
Argentina	4.4	50.3	11.43	69
Brazil	2.0	66.6	33.30	93
Chile	4.5	51.3	11.40	86
Colombia	2.8	59.4	21.21	94
Costa Rica	3.3	54.8	16.61	93
Ecuador	1.8	72.0	40.00	47
Mexico	4.2	63.2	15.05	70
Panama	2.0	61.8	30.90	72
Peru	1.9	61.0	32.11	40
Uruguay	4.4	47.5	10.80	80
Venezuela	3.0	54.0	18.00	89
Average	3.1	58.4	21.89	76
Dynamic East Asia and China:				
China	7.0	39.0	5.57	88
Hong Kong 1/	6.0	49.0	8.17	98
Singapore	6.5	49.2	7.57	58
South Korea	6.5	45.2	6.95	100
Taiwan 2/	8.8	37.2	4.23	58
Thailand	5.6	49.8	8.89	34
Average	6.7	44.9	6.70	73
South and Southeast Asia:				
India	4.7	53.1	11.30	11
Indonesia	6.6	49.4	7.48	24
Malaysia	3.5	56.0	16.00	28
Philippines	3.9	53.0	13.59	26
Sri Lanka	6.9	44.9	6.51	53
Average	4.5	51.3	11.40	28
Sub-Saharan Africa:				
Cote d'Ivoire	2.4	61.4	24.58	14
Kenya	2.6	60.4	23.23	17
Average	2.5	60.9	23.91	15

1/ British Crown Colony. 2/ Province of China.

By this measure, South Korea is the most homogeneous developing country, Tanzania the least. 2/ The derailment of growth due to ethnic redistribution struggle is, unfortunately, not uncommon. Sri Lanka, Lebanon, and, most recently, Yugoslavia provide contemporary examples of formally successful growth which has been undercut by ethnic strife. The high level of ethnic homogeneity in Japan, South Korea, and Taiwan helped lead to consensus politics and a productive nationalism which provided the conditions for long-term investment and private control of the economy. 3/

Table J-3 provides some summary statistics of the previous tables showing mean values for each variable introduced for Sub-Saharan Africa, Asia, and Latin America. There are some clear differences among the regions.

Attention has focused recently on the causes of the performance gap between Latin America and Asia (1, 2, 3, 8, 10, 11). Many of Latin America's economic problems are attributed to the interaction of open political systems and high levels of income inequality. This combination often gives rise to "populist" economic policies. Populist policies usually result from ambitious election promises made to gain the support of the urban poor. The increase in public (deficit) spending brings about higher incomes in the short run, but leads quickly to increased state control of imports, lending, and prices. The ultimate effect is high inflation and a sharp decline in real incomes, often accompanied by a change in government.

Africa's political and economic record since independence (except short-term windfall gains in petroleum exports) has been so abysmal, little attempt has been made to contrast its performance with that of other regions.

Many attribute Africa's problems to a poor resource base, harsh climate, and posit a variety of conspiracy theories indicting developed countries. It is generally agreed that Sub-Saharan Africa has more than its share of interventionist

governments harboring strong anti-market biases and prepared to repress political expression. The only African nation to remove an incumbent government by election has been Mauritius, which has the unique combination, for Africa, of an open political system, a strong civil liberties code, and a market economy.

Table J-3 reveals Asia to be less open politically than Latin America, and less ethnically homogeneous, but Asia also has significantly less income equality. As noted earlier, it has tended to be more export-oriented (although not necessarily more market-oriented) than Latin America. It may be that Asian countries may not have latched on to some success formula. Rather they have not been induced into making major policy blunders by their relatively low income inequality. 4/

A Revolution in Development Policy?

Analyses of the comparative economic performance of developing countries show that economic growth and government management of the economy are negatively related. The record indicates that developing countries are not essentially different from industrialized countries in their earlier development stage. Individual households and firms have a greater chance of realizing their potential if allowed to respond to market opportunities rather than to the distorted signals of government policies.

These findings do not suggest that no government at all is desirable. Governments have a real advantage in providing essential services like an efficient economic and physical infrastructure and an effective and consistent legal system.

The superior economic performance of open economies has not gone unnoticed by developing countries, many of which have liberalized—or are now in the process of liberalizing—their economies.

Table J-3--Summary statistics

Variable	Mean values by region		
	Africa	Asia	Latin America
Political 1/	5.70	3.88	3.10
Civil 2/	5.67	4.50	3.45
Economic 3/	2.44	1.63	1.80
Growth 4/	0.68	5.19	1.36
Ethnic 5/	31.37	53.25	74.05
Inequality 6/	NA	7.81	21.40

NA = Not available. 1/ 1 = Most open, 7 = most closed. 2/ 1 = Individual/rule of law, 7 = state/fiat rule. 3/ 1 = Market, 5 = command. 4/ Annual percent growth rate of per capita GDP. 5/ 100 = Maximum homogeneity, 1 = minimum heterogeneity. 6/ Share of income received by high quintile divided by share of income received by low quintile.

Sources: Political, civil, and economic: (5); growth: (6); ethnic: (7); and inequality: (1).

This trend toward open economic policy is likely to accelerate in the 1990's, particularly as the archetypes of central planning, the USSR and China, are engaged in domestic political struggles to liberalize their own systems. Since 1985, liberalization has occurred in Bolivia, Mexico, and Nigeria; and more moderate reforms in Argentina, Brazil, Costa Rica, India, Kenya, People's Republic of China, and Tanzania. At the moment, there are even indications of a movement toward openness by such traditionally hardline regimes as Albania, Ethiopia, and Vietnam. Certainly, there has been a major shift in what policymakers and their advisors believe about the effects of economic policy on growth.

Notes

1/ One should note that the distribution of wealth is even more unequal than the distribution of income.

2/ In this list Japan ranks fifth, and East and West Germany ninth and tenth—all pre- and post-World War II economic “miracles.”

3/ Hong Kong, a British colony, is almost all Cantonese; similarly, the Chinese Special Economic Zones, which had extraordinary real growth rates in the 1980's, rank high in homogeneity. On China's rural development “miracle” see (9).

4/ Several analysts have noted that Colombia is atypical of Latin America, particularly in terms of its strong democratic tradition and market orientation. The Philippines bears more similarity to the Latin American norm than the Asian norm, particularly in terms of its high income inequality and political and trade regime.

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Currency Convertibility in Eastern Europe and the USSR: Issues, Effects, and Prospects

by
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Abstract: Currency inconvertibility is inherent in centrally planned economies due to the very nature of the planning process and the associated “irrational” pricing system. Results of this situation include strictly bilateral trade, absence of international trade specialization, lack of functional exchange rates, and difficult access to international financial markets. Disintegration of the central plan system in Eastern Europe, however, has allowed initiation of market-oriented reforms, including introduction of convertible currencies. In the USSR, a convertible ruble is not likely to appear soon.

Keywords: Currency convertibility, central planning, financial markets, Eastern Europe, USSR.

Currency convertibility, an old problem in international trade, has emerged as one of the crucial issues in the debate on economic reforms in Eastern Europe and the USSR as these countries begin to emerge from the autarky imposed by the Soviet economic system.

The convertibility issue began to be seriously debated in official circles and the national press of the region during the second half of the 1980's in response to growing political liberalization and mounting economic difficulties, including failing agriculture, technological backwardness, uncompetitive industries, unsatisfactory trade-sector performance, and increasingly burdensome external debt servicing. This issue is closely associated with the broader, and more complicated, problem of the region's intra- and extra-bloc trade system and with the whole issue of economic reform. However, the discussion in this article is generally limited to the narrower problem.

Up to 1990, Eastern Europe and the USSR were part of the centrally planned economies (CPE's) group. Though the CPE system is rapidly dissolving, the Soviet bloc CPE's are still officially grouped into a Soviet-dominated intergovernmental Council for Mutual Economic Assistance (CMEA), also known as Comecon. The Council was established in 1949 with the objective to improve and coordinate the planned economic development and integration of member countries. Later revision of its charter stressed the promotion of economic cooperation in foreign trade, joint industrial projects, and the coordination of national economic plans.

For political as well as economic reasons, the USSR forced the other CMEA countries into a high level of intra-bloc trade. Eastern European countries are now trying to extricate themselves in favor of more profitable East-West trade.

In 1963, the CMEA countries founded the International Bank for Economic Cooperation (IBEC) as an intra-CMEA clearinghouse to carry out multilateral settlements in bloc trade, using the so-called “transferable ruble” as an intrabloc unit of account.

Definition of Currency Convertibility

There seems to be no clear definition in professional literature of the currency convertibility concept, particularly as there are differing degrees of convertibility. Western authorities on the subject generally distinguish between “full” and “partial” (or “quasi” or “incomplete”) convertibility. Eastern European and Soviet writers, looking at the problem from their own experience and institutional base, speak more often in terms of external and internal convertibility.

A currency is generally considered fully convertible if its holders can exchange it freely, without a government license, for any other currency or gold, regardless of either the purpose of conversion or the identity of the holder of the currency, and can take it freely out of the country. The two qualifications, purpose of conversion and identity of the holder, provide the distinction between full and partial convertibility. Today, only 61 of the 152 member countries of the International Monetary Fund have fully convertible currencies (9).

A fully convertible currency is generally accepted as an international currency, such as the U.S. dollar, the Swiss franc, or the British pound sterling. To act as an international medium of exchange a currency should be generally acceptable (1) in international trade as a transaction currency; (2) as a store of value; (3) as an intervention currency (to buy or sell foreign exchange against one's own currency to maintain a fixed exchange rate); and (4) as a vehicle currency (a third currency in which two countries denominate and conduct their trade) (6).

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A currency is *partially convertible* if the exchange privilege is limited to current transactions only and is subject to government controls with respect to capital transfers. This is also known as current account convertibility. It was adopted by many European countries in the 1950's as a first step toward full convertibility. Other instances of partial convertibility occur in market economies when limitations on free currency convertibility are placed because a currency is overvalued due to inflation or some fundamental structural factors, and imports tend to exceed exports. In such cases the balance of payments is maintained by restricting imports, thus putting limits on convertibility for residents. Nonresident foreign exporters, however, are allowed to convert the earnings of the currency in question into their own currencies (3, 6). Two other cases of partial convertibility include territorial and transaction limitations, the first restricting convertibility to a specific group of countries and the latter to some activities, such as tourism, joint ventures with foreign partners, and the like.

Another aspect of currency convertibility relates to its impact, either internal or external. *Internal convertibility* means it is the responsibility of the central bank, or a bank with an authority to deal in foreign currencies, to provide to or accept from foreign or national economic entities engaged in foreign operations, foreign and national currencies and convert them to the currency of a target country. In Poland today, it obliges economic entities to sell all their foreign exchange earnings, but gives them the right to buy convertible currencies in order to pay their foreign exchange obligations. Private individuals are allowed to own and dispose of foreign currencies as they see fit (13). *External convertibility*, in contrast, allows authorized banks or other agencies to exchange directly among themselves, or through other organizations, the national currencies of partner countries. This, in effect, authorizes foreign business entities to buy or sell a specific currency for another foreign currency, outside the sphere of influence of the issuing centers of each of those currencies (6, 8, 9).

Currency Nonconvertibility In Centrally Planned Economies

The basic reason for currency nonconvertibility in CPE's, at least in the Soviet model, is the centrally planned character of the economy and the resulting pricing system. In this model, prices are generally set by the planners for accounting purposes rather than their being determined by the market.

Such prices have some relevance to planning but, because they exclude certain costs, such as interest charges on capital, and measure other costs inaccurately, they do not balance supply and demand. Hence, these prices have been commonly described as "irrational" and play almost no role in the allocation of scarce resources. Under such a pricing

system, an independent trade at the enterprise level would result in economically irrational trade, and the currency inconvertibility precludes such a trade.

Traditionally, foreign trade in CPE's was in the hands of a limited number of state monopolies organized as foreign trade organizations (FTO's). Decisions such as what to import or export, however, were not made by the FTO's but by central planners who had to fit foreign trade into their material balances for each commodity. The exported commodities were typically those produced in excess of domestic needs and the imported commodities were those which were in short supply domestically. Foreign trade was also used to correct occasional planning imbalances.

However, unplanned trade, particularly unplanned export trade, was not allowed because it would upset domestic commodity balances and create a potentially negative multiplier effect on related sectors of the economy. This created the *commodity inconvertibility* situation in the sense that nonresidents who wanted to buy CPE-exportable goods could not convert their foreign exchange into these goods unless the transaction had been planned in advance. This, in effect, meant that foreign importers could not compete with domestic enterprises for products allocated under plan. Commodity inconvertibility thus constituted a serious constraint on the ability of CPE countries to compete on international markets (6).

Reliance on a central plan requires currency inconvertibility which results in a strong tendency towards bilateral trade, particularly among the CPE's, because their currencies cannot be used to cover trade deficits. As a result, these countries prefer to arrange their trade through annual and long-term bilateral trade and payment agreements. In theory, such agreements allow both nations to move the needed goods quickly with firm commitments. The CPE's would have liked to have similar agreements with market-economy countries, but this was impossible because governments in market-economy countries do not control private trade enterprises.

The CPE's recognize multilateral trade's advantages and have, over time, increased its scope. However, currency inconvertibility and the central planning system make it difficult to get away from bilateral trade. Since no nation would hold balances in nonconvertible CPE currencies, trade transactions of these countries had to balance. But, the overall payments balance that needed to be maintained tended to reinforce the bilateralism of trade and financial settlements (7).

The Price of Nonconvertibility

Currency inconvertibility in the Soviet bloc countries was primarily a result of Soviet-imposed centrally planned systems, inward-oriented development strategies, and national

self-sufficiency goals in which foreign trade was viewed not as enriching the country, but as a source of potential disruption of central planning. While this posture may not have been totally unrealistic for the vast and diversified USSR, it made much less sense for the smaller economies of Eastern Europe which traditionally depended heavily on foreign trade. Such policies have cut off these economies from international trade and encouraged the development of local industry by protecting internal markets that proved too small to support modern technology. The resulting lack of convertible currencies prevented the bloc countries from taking advantage of international trade specialization, free competition, and access to international financial markets. It locked the region within the least-common-denominator borders of economic-performance and technology-level standards.

Currency inconvertibility prevents the formation of currency markets, and thus the formation of functional exchange rates, that is to say economically meaningful, market-determined rates. The artificially determined rates are then necessary, but because they are arbitrarily determined they are of little use in a rational planning of foreign trade. This seriously complicated and constrained the countries' foreign trade and other financial transactions.

Also, currency inconvertibility may be, to a large extent, responsible for the bloc's consistently running hard-currency trade deficits and growing external debts which, by 1989, had reached close to \$120 billion in the seven Eastern European countries and \$48 billion in the USSR. This is nearly 14 percent of the world's total external debt, for a region that represents only 8 percent of the world's population and probably between 15 and 20 percent of the world's gross national product (14). Most of this debt was accumulated after 1971, when it was only \$8.2 billion for Eastern Europe, and \$1.8 billion for the USSR. This point was argued by Holzman (6) as early as 1974, and was reinforced by subsequent developments in the bloc's balance of payments.

There are a number of reasons for the debt's accumulation. These include a relatively low proportion of high-priced manufactured products in the bloc's exports but a high proportion of such products in its imports. This was due to relatively poor quality of the bloc's manufactured products, the planning process and the consequent rigid distribution process which could not be adjusted easily to suit market conditions, "commodity inconvertibility" which resulted in rigidly bilateral trade within the bloc and which did not allow foreign buyers to shop at will in the CPE markets because this could be disruptive to the country's plans, inability to adjust imports to a level that could be supported by exports, and, finally, distorted domestic prices which forced bloc countries to use different prices in intrabloc trade than in East-West trade (6, 7).

Currency Convertibility in Eastern Europe

The negative effects of currency inconvertibility were recognized quite early, particularly in Eastern Europe. A number of efforts were made to achieve a degree of convertibility or, at least, to bypass the problem.

The first attempt in 1963 involved the establishment of the already mentioned bank, the IBEC, and the new "international" currency, the transferable ruble (TR). The major purpose was to get away from strictly bilateral transactions and achieve a truly multilateral intra-bloc trade using TR's to settle account imbalances. This, however, did not change the situation. TR's proved no more convertible than domestic currencies of the bloc countries and the rigid trade bilateralism remained in force.

Because of commodity inconvertibility and irrational prices, TR's could not perform money's traditional function. They could not be spent freely in CPE markets, and other countries did not want to hold a nonconvertible currency which paid only 1 percent interest on outstanding balances. Nor could TR's serve as an effective unit of account, having no connection to world prices. Also, as the bloc countries refused to run surpluses with each other, because none wanted to accumulate TR's, the TR could not serve as a store of value.

In 1971, the CMEA countries adopted, at the Soviets' initiative, the so-called "Complex Program" in order to accelerate the process of far-reaching integration among member countries. The program included harmonizing economic policies, coordinating pricing and taxation systems, uniform economic regulatory instruments, and currency convertibility. This meant, at this stage, bilateral convertibility between the ruble, as the leading currency, and the currencies of the member countries—effective by 1980. However, there was little enthusiasm for the program among the Eastern European CMEA members, and the proposal remained a paper goal.

A new "Complex Program," with a similar agenda but stressing the currency convertibility issue more directly, was launched in 1985 with similar results. It has been ignored by Eastern European countries (4).

In the meantime, there were two direct attempts to remedy the currency inconvertibility problem. One was a 1975 proposal to create an externally convertible ruble (ECR) to be used exclusively in East-West trade. The ECR would be a purely financial instrument that could only be exchanged into Western currencies and used in the West. Only a Western trader holding ECR's could use them to purchase goods in another Western country. To create ECR's CMEA member countries would make deposits in the IBEC, or some other financial institution, against which they could draw ECR's to pay hard-currency debts to nonbloc countries. A portion of the deposit was to be made in convertible curren-

cies and/or gold. The proposal failed because the ECR could not act as an international currency, competing with the dollar or other Western currencies.

The other attempt, a year later, consisted of encouraging Western banks and exporters to accept TR's in trade payment instead of major Western currencies. One of the reasons for this step was to expand CMEA countries' short-term credit availability without borrowing directly from Western banks or businesses. Again, no country wanted to acquire or hold TR's (6).

The issue of currency convertibility of CMEA countries kept surfacing in the press and in official pronouncements of East European officials, but there was little progress until the end of the 1980's. While the desirability of achieving full currency convertibility within CMEA and with Western countries was generally recognized, achieving it was not thought possible for at least another decade. The argument against moving faster was always the same—the need to protect the domestic price structure and the planning mechanism from the disturbing influences of the world market (1, 4, 8). The Czech press used this argument and the timetable as late as 1989 (8, 11). However, in Poland the argument was considered outdated as early as 1987, when the necessity of accelerating drastic economic reforms and joining the world trading system was clearly recognized (1). Historical experiences, no doubt, played their role too, as an argument was occasionally advanced that the currency convertibility will have to wait until Eastern European economies become stronger. However, before the War, when Poland's economy was probably as weak as it is now and experienced a deep crisis in the 1929-32 period, Polish currency remained relatively strong and even improved against the U.S. dollar, from Zł.8.91 in 1930 to Zł.5.30 in 1938 (10).

The issue was settled in August 1989, when the Communist-dominated government in Poland was finally allowed to collapse and the Solidarity-dominated government was installed. The new authorities moved quickly to initiate a drastic and aggressive process of converting the Polish economy to a free market system, thus eliminating practical obstacles to currency convertibility.

By January 1990, the zloty was devalued and stabilized at a realistic rate of its black-market value, all private foreign currency exchange operations were decriminalized, and the zloty made convertible, with its rate of exchange to be set by the free currency market. In practical terms, however, the convertibility is "internal," "quasi free," or "limited" until proper free market economic institutions have time to get established—most importantly the private banking system. At the same time, foreign currency auctions run by the central bank, instituted only a few months before, were abolished.

About the same time, Yugoslavia also introduced an internal convertibility of its dinar and pegged it to the West German mark (16). The Hungarian Government, the first among the CMEA countries to start moving towards a free convertibility of its forint, in practice proceeded cautiously in restructuring its economy and taking the final convertibility step. It now set a 2-year timetable to put it into effect.

Likewise, the Czechoslovak Government adopted on April 12, 1990, a master plan to bring the country to a full market economy, including a speedy rectification of a highly deformed price structure, and set the date for introducing the internal convertibility of the koruna by January 1991 (2). Thus, with the East German mark set for extinction under the West-East German unification agreement, to be implemented in July 1990, most East European countries are moving to rejoin the world trading system and are instituting a degree of free currency convertibility.

Currency Convertibility in the USSR

The idea of ruble convertibility as a separate issue from the regional currency convertibility, covered in the previous section, has been circulating in Moscow since the mid-1980's. It was specifically raised at the June 1987 meeting of the Central Committee of the Communist Party of the Soviet Union and then widely discussed in the Soviet press. A decision was apparently made at the meeting to move toward eventual ruble convertibility, initially within CMEA and then in the world. However, most of the Committee members seemed to believe that the achievement of a fully convertible ruble, or even a ruble convertible just within CMEA, can only be a long-term goal, probably not attainable before the year 2000 (5).

Ruble convertibility has now become one of the main goals of the current economic reforms. However, since making the existing ruble convertible is likely to take a long time, given the slow progress of economic reforms in the country, a proposal was floated to create an interim second currency, a ruble backed by gold and hard currency reserves.

The idea is not new. It was tried in July 1922, during Lenin's New Economic Policy period, in the form of a special golden ruble issue, called "chervonets." The move was to be supported by a balanced state budget. Without drastic reforms to improve the economic performance the move failed. Another proposal advanced last year was to adopt the gold convertibility for the ruble in general. This meant, in practice, the USSR's adopting the gold standard for its currency. The idea was greeted, however, with the apprehension that it would lead to a run on Soviet gold stocks (15).

Any form of ruble convertibility will require a drastic price reform that would allow the Soviet economy to link with the world economy. But the ruble has already become a runaway currency because of an increasingly unbalanced domestic budget leading to continuously larger deficit financing.

The Soviet authorities decided, therefore, that as long as strong inflationary pressure exists, major price reform cannot be introduced. Consequently, only two relatively small steps have been taken so far toward ruble convertibility.

First, a limited auction of hard currencies was introduced last November. Initially, only state enterprises can bid for the currency sold by the banks from the \$30 billion of existing foreign reserves, with the auction exchange rate close to the black market rate. While the official exchange rate is 0.63 rubles to the dollar, on the black market the ruble trades at present at about 15 rubles to the dollar. Over time more state enterprises and joint ventures are supposed to be allowed to bid at the auction. Eventually, it is expected that Soviet banks will trade rubles daily as the exchange market becomes more like a regular foreign exchange market, and the number of Soviet banks participating in the trade will grow to 120.

The second step was to create a "special exchange rate" for personal transactions.

Foreign tourists changing hard currencies for rubles are now allowed to get 10 times more rubles than previously. The new exchange rate, valuing the ruble at \$0.16 instead of the official rate of \$1.60, is available to any foreign visitor changing hard currency or travellers' checks. The rate applies to withdrawals from foreign residents' hard-currency bank accounts. This rate also applies to Soviet citizens travelling abroad, whether on private or official business. They are entitled to the same amount of hard currency, just over \$300 per person, but it costs them 10 times as much (15). However, the old and unrealistic exchange rate still applies to all trade transactions, including services.

Apparently, there is nothing pressing in the need to boost Soviet exports, discourage imports, or attract investment. Both reforms, the hardcurrency auction and the tourist exchange rates, were introduced in November 1989, and their performance is still difficult to assess. However, foreign tourists and businessmen visiting the USSR already pay 80 percent or more of their costs in hard currencies (2).

Conclusions

Currency convertibility is generally viewed in Eastern Europe and the USSR as the principal step in emerging from decades of economic isolation and rejoining the world trade system. As such, it has been made an essential part of the radical economic reforms now sweeping the region.

Nearly all East European countries have expressed the intention of introducing currency convertibility, and the press has extensively discussed the issue. Most of the countries have devalued their currencies, removed many previously existing

trade barriers, and are in the process of introducing other market-oriented reforms.

As of this writing, however, only Yugoslavia and Poland have introduced, in January of this year, the "internal" convertibility of their respective currencies, as the first step toward full convertibility.

Czechoslovakia and Hungary have been more cautious, trying to avoid the destabilizing effect of sudden price deregulation, but will make the transition within the next 2 years. Czechoslovakia has already scheduled it for January 1991, and Hungary by mid-1992.

In Bulgaria and Romania, Communist-dominated governments, albeit reformed and bearing other names, are still in control. Since all these countries aspire to eventually join the European Community, full currency convertibility will remain an important and pressing goal.

The USSR seems to be in a different category. Radical economic reforms, including ruble convertibility, are currently widely debated in the press and within the Government establishment, such as in the Supreme Soviet and the newly created Presidential Council. Appropriate decisions, however, are periodically postponed. It seems, therefore, that the implementation of a decisive reforms package may be delayed "indefinitely" in view of a widespread prejudice of the Soviet people against free-market types of reform and an apprehension regarding their results (2). Without drastic reform of the economy there cannot be ruble convertibility.

The introduction of convertible currencies in Eastern Europe is likely to affect the development of the countries concerned as well as their trade with the West. To what extent, however, is not certain.

From the point of view of economic development, the convertibility will allow at least some foreign capital to flow into region by way of joint ventures and other investments and also allow the evacuation of a portion of generated profits. This will no doubt help to upgrade the countries infrastructure, improve the technology of their industries, and improve their competitiveness on world markets. This, however, will likely be a slow process.

Insofar as trade is concerned, convertibility will end the need to stress bilateral and countertrade arrangements, thus improving the efficiency and scope of the trade. But these countries' imports will still depend on their ability to generate export earnings. Hence, Eastern Europe may continue for some time to stress self-sufficiency and export promotion, this time, however, on the basis of a more rational price structure and better prospects for economic recovery.

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Dealing with the External Debt Problem

by

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Abstract: The external debt problem of Latin America, Africa, and Eastern Europe continues to affect adversely the world trading system. Despite the growth in the world economy during the last half of the 1980's, the most heavily indebted nations continue to suffer the consequences of extensive borrowing in the 1970's. Economic indicators, such as national income growth, trade, consumer prices, and investment show that these countries remain debt constrained.

Keywords: Debt problem, developing countries, debt repayments, trade, growth, debt reduction.

The external debt problem, most seriously affecting Latin America, Africa, and Eastern Europe, remains unresolved despite the strain it has placed on global trade and development for almost a decade. Various debt resolution strategies that have been discussed, negotiated, and attempted are just now being implemented. Yet, by standard measures, it appears that this problem will be with us for some time to come.

Few of the debtors that have rescheduled their debts since 1982 have been able to stick with their new payment obligations. Many economic indicators that told us in the early 1980's that a debt problem was upon us continue to tell the same story. The debt problem has hardly diminished, and its harmful effects on debtor countries, on U.S. exports, and on world trade persist. This is true despite a variety of strategies devised to ameliorate the problem. Recent discussions in the economic literature may provide some insight into why this problem is so intractable, and why the solutions have had minimal success.

The Causes

The current world debt problem had its roots in the rapid economic growth of the 1960's and early 1970's. The growth was predicated on policy regimes and outmoded capital market structures that helped create the illusion of accessible and inexpensive primary products. This situation led to excess demands for natural resources, including petroleum, and provided the preconditions for the formation of the Organization of Petroleum Exporting Countries (OPEC) which became an effective world cartel.

The fourfold increase in petroleum prices initiated by OPEC in 1973-74 provided a substantial shock to the world economy. The principal short-run effect was to throw most trading countries into balance-of-trade disequilibrium. Oil-exporting countries, particularly the high-income export-

ing countries, generated large trade surpluses, forcing oil-importing countries into persistent balance-of-payments deficits. This process led to a significant and rapid accumulation of external debt in the Third World and East European countries and set the stage for the current world debt problem.

The policies pursued by the industrial countries also contributed to the debt accumulation process by employing easy monetary policies before and after the first oil shock. The change in trade flows and expansionary monetary policies in the Organization for Economic Cooperation and Development (OECD) nations generated liquidity that had previously been unavailable to the international financial system. As a result, economic growth in developing countries (LDC's) could continue with only a minor slowdown in 1974-75.

International bankers recycled this liquidity, partly in the form of petrodollar deposits, by beginning a massive lending program on easy terms, focused primarily on middle-income LDC's and Eastern Europe. They anticipated higher returns in the unregulated international market, as compared to returns available in highly regulated domestic markets. A country's guarantee seemed adequate provision against repayment defaults. The question of whether the funds were being invested to earn a stream of foreign exchange sufficient to repay the loans was, in retrospect, not adequately considered.

While the oil price rise of 1973-74 provided the impetus for the debt buildup, the second oil shock of 1979-80 set the stage for the world recession of 1980-83. The second oil price increase was much different from the first because of the previously accumulated debt and the far different policy responses of the industrial nations.

The rapid inflation precipitated by the 1973-74 oil price increase proved politically unacceptable to the industrial countries. Large increases in resource costs and changes in comparative advantage were killing profits for primary-resource industries. After 1979-80, a sudden drop in monetary growth sharply slowed the growth in the world

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economy, raised real interest rates, and led to squeezing off the flow of credit to debtor nations. This unanticipated, and virtually unanimous, policy response of the industrial market countries to the second oil shock provided the environment which resulted in the current repayment problems of some of the largest debtor nations.

Debtor-country policies also proved fundamental in the process. Countries that had pursued export-led development strategies faced adjustment problems from the change in the world economy in the early 1980's. However, their economies were flexible enough, with discipline learned through international competition, to adapt to the rapid shifts that occurred during the 1980's. Examples of countries that were heavy debtors, yet escaped much of the problems of excessive debt service, were South Korea, Taiwan, Malaysia, and Thailand (1).

The countries that practiced import substitution and inward-oriented policies faced greater difficulties. This group includes most countries in Latin America, Africa, and Eastern Europe. They tend to comprise the majority of those now facing debt-servicing difficulties and limited access to international credit. The problems with these inward-looking countries included:

- The use of borrowed funds for direct investment, with the guaranteeing government as the agent. There was little way for the principal (the lender) to observe a direct relation between a loan and an investment. Thus, some of the borrowed funds could be used for current consumption (1).
- There was a movement toward publicly-owned monopolies, insulated from foreign competition, which tended to provide a vehicle for rewarding politically influential groups, rather than an efficient use of country resources.
- The heavy reliance on exports of primary products and partially assembled manufactured goods, combined with the capital demands of state enterprises, meant that competition in the world marketplace was deemphasized and innovation was stifled.

These countries had to adjust from being net importers to net exporters. State-owned enterprises and relatively consumption-oriented economies were unaccustomed to international competition. The result was that they could not suddenly switch their production mix to earn enough foreign exchange to repay debts and remain creditworthy.

There is no clearer view of the above than the comparison between the most heavily indebted countries and the newly industrializing countries (NIC's) of East Asia. The countries with the largest debt which have attempted to reschedule are principally defined by the International Monetary Fund

(IMF) as Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia, but they also should include Bulgaria, Hungary, and Poland. This group shows exports at \$150 billion in 1981, falling to \$124 billion in 1986, before reaching an estimated \$155 billion in 1988. On the other hand, the four NIC's (Hong Kong, South Korea, Singapore, and Taiwan) exported \$84.5 billion in 1981, \$130 billion in 1986, and nearly \$220 billion in 1988. They had practiced export promotion during the 1970's, an experience that permitted their adjustment to external adversity in the 1980's.

The Current Situation

Through 1980, debt repayment problems did not pose a serious threat to either the world financial system or global trade. In the 25 years from 1956 to 1980, only 22 countries were involved in debt reschedulings, and the total amount rescheduled was only slightly more than \$21 billion. The pattern of international debt reschedulings since 1980 indicates a serious mismatch between the LDC's and Eastern Europe's payment commitments and their actual ability to pay.

Twenty-five countries rescheduled debt totaling \$55 billion between 1981 and 1983. There has been continuing escalation in the amount of debt rescheduled since then. In 1984, 23 countries renegotiated almost \$34 billion. By 1985, the amount had increased to \$93 billion. And in 1986 and 1987, there was a further increase to \$122 billion and \$144 billion, respectively. This escalation in the number of countries involved and the magnitude of the reschedulings was a clear indication that the disparity between payment capacity and payment requirements had continued to worsen.

However, the problem has recently taken on a more ominous note. There are approximately 40 countries currently seeking debt restructurings from commercial banks (5). Yet, in 1988, only one restructuring "package," for Brazil, was completed (11). Mexico had virtually the only major successful restructuring in 1989 (partially a result of United States intervention), and only Venezuela in 1990. Banks are not offering rescheduling as readily as in 1983-87.

World total external debt exceeded one trillion dollars in 1986 and increased to \$1.2 trillion in 1988 and 1989 (8, 10). The annual growth rate of debt exceeded 20 percent between 1973 and 1981 for all indebted countries, but only 7 percent between 1981 and 1988 (table L-1).

Recent trends in the growth of debt are mirrored in the case of the 18 most heavily indebted countries. They had \$371 billion in debt as of 1981, peaking at \$550 billion in 1987. Since that time, their total debt has been reduced to about \$534 billion in 1988, but it increased again to \$538 billion in 1989. The NIC's, on the other hand, had external debt of

Table L-1--Total debt, debt service ratios, and debt ratios for developing countries and Eastern Europe.

Item	1981	1982	1983	1984	1985	1986	1987	1988	1989
Billion dollars									
Total debt									
Developing Countries	731.5	826.6	878.7	918.3	995.5	1,086.7	1,200.2	1,197.2	1,193.7
Sub-Saharan Africa	49.3	54.0	56.4	58.7	68.7	81.0	97.5	100.2	101.7
Newly-industrialized countries	42.8	50.2	53.6	55.8	59.2	61.5	59.5	53.7	46.5
Heavily-indebted countries	314.8	361.8	377.2	390.2	404.7	429.1	466.3	450.8	449.2
Eastern Europe 1/	85.8	80.6	82.1	79.6	88.3	100.4	114.6	111.8	117.1
Percent									
Debt service ratio									
Developing Countries	16.1	19.5	18.4	19.7	20.7	22.8	19.8	19.9	17.0
Sub-Saharan Africa	21.4	23.7	23.2	26.3	26.5	26.4	24.0	24.8	27.2
Newly-industrialized countries	7.6	8.2	7.9	8.3	8.5	9.1	10.9	5.7	3.4
Heavily-indebted countries	40.9	51.6	41.6	41.5	40.5	45.6	35.9	43.2	39.0
Eastern Europe 1/	N.A.	87.5	68.8	48.7	47.5	53.1	48.7	48.9	48.7
Debt to GDP ratio									
Developing Countries	27.7	30.6	32.6	33.6	35.5	37.5	37.1	34.1	31.3
Sub-Saharan Africa	45.9	51.2	53.5	57.7	64.8	66.8	75.4	69.4	70.4
Newly-industrialized countries	29.2	32.9	33.0	31.1	32.2	28.8	22.0	15.9	11.6
Heavily-indebted countries	37.6	41.0	46.2	46.7	46.0	45.1	44.2	39.7	38.3
Eastern Europe 1/	16.9	15.7	15.9	14.5	16.0	18.4	19.4	19.0	17.8

Source: International Monetary Fund, and, for Eastern Europe, U.S. Government Sources and Authors' calculations.

1/ Includes Yugoslavia but excludes the USSR.

N.A. = Not available.

\$42.8 billion in 1981, \$61.5 billion at their peak in 1986, and \$47 billion estimated at the end of 1989.

A long-term indicator of a country's ability to repay debt is its debt-to-GDP ratio. This represents the proportion of GDP that would be required to be turned over to repay all external obligations. A lower value generally indicates a good candidate for more credit.

However, factors such as economic growth and political stability are also important considerations. LDC's, as a whole, have seen this ratio increase from 27.7 percent in 1981 to 31.3 percent in 1989, with the peak at 37.5 percent in 1986 (table L-1). The highly indebted countries had debt measured at 37.6 percent of GDP in 1981, rising to 46.7 percent in 1984, before falling to 38.3 percent as of 1989. The NIC's began the 1980's with debt at 29 percent of their GDP, rising to 33 percent in 1985, before plummeting to less than 12 percent in 1989.

A measure of the short-term pressure of debt is often expressed as the ratio of debt payments to the value of exports of goods and services, also known as the *debt service ratio*. The higher the debt service ratio, the more difficult it is for a country to meet its near-term contractual obligations. The fact that the highly indebted countries continue to reschedule indicates that they, in combination with their creditors, have consistently overestimated their ability to meet even next period's payments.

The highly indebted countries began the 1980's with a debt-service ratio of 37.6 percent in 1981 (table L-1). This soon rose to 46.7 percent in 1984, declining gradually to just over 38 percent in 1989. The NIC's also saw their debt service ratio rise in the early 1980's, from 29.2 percent in 1981 to 33

percent in 1983. However, rapid export growth and debt repayment lowered the NIC's ratio to less than 12 percent in 1989.

The withdrawal of credit to the debtor countries, most of them LDC's, is magnified when the net flows of credits to these countries between 1973-85 are considered. Between 1974 and 1982, the cumulative net inflow of credit to LDC's and Eastern Europe equaled approximately \$200 billion. Starting in 1984 and continuing through 1987, there was a net outflow of credit from LDC's in excess of \$100 billion. Net transfers out of LDC's have moved from almost \$22 billion in 1984 to \$38 billion in 1986 and to more than \$50 billion in 1988 and 1989 (10).

The continued failure of the rescheduling process is a signal that the international financial community may have mistaken a problem of solvency for one of liquidity (9). The recognition that potential debt repayments no longer match obligations has led to general agreement that some type of debt writedown is necessary to stimulate economic recovery and trade.

The Consequences

The most obvious feature of the economic landscape in the most heavily indebted countries has been the erosion in per capita incomes over the 1980's (table L-2). During the 1970's, the average increase in per capita incomes in the highly indebted countries was just over 3 percent. Negative per capita GDP averaged almost 2.5 percent in 1981-4, corresponding to the world recession years. However, per capita growth did not recover to its previous levels and declined again in 1988 and 1989. The 1981-84 decline in growth may be ascribed to the recession, but why the last half of the 1980's has not produced more robust growth remains a question.

Table L-2--Performance indicators for selected groups of developing countries and Eastern Europe.

Item	1981	1982	1983	1984	1985	1986	1987	1988	1989
Percent change									
Per capita GDP growth									
Developing Countries	-0.6	-0.9	-0.3	2.2	1.8	1.9	1.6	2.1	1.2
Sub-Saharan Africa	-1.7	-4.6	-5.1	3.4	1.1	1.1	-0.9	-0.8	-0.7
Newly-industrialized countries	5.2	2.9	7.8	8.2	3.2	10.0	10.9	8.4	5.3
Heavily-indebted countries	-2.3	-2.6	-4.8	-0.1	1.6	1.8	0.4	-1.0	-1.6
Eastern Europe 1/	-1.9	0.1	1.3	2.6	1.0	2.1	0.7	1.6	0.6
Consumer prices									
Developing Countries	25.8	25.4	32.7	38.5	40.6	31.4	41.6	70.8	85.5
Sub-Saharan Africa	29.3	19.1	25.7	21.6	19.8	21.0	24.0	22.6	19.0
Newly-industrialized countries	17.6	6.2	3.6	2.5	1.6	1.8	2.3	4.6	5.7
Heavily-indebted countries	53.7	55.5	91.0	118.3	122.9	77.4	116.6	248.6	356.4
Eastern Europe1	N.A.	N.A.	N.A.	16.7	24.4	49.0	63.5	155.0	N.A.
Percent of GDP									
Gross capital formation									
Developing Countries	26.5	25.2	23.8	23.5	23.4	23.2	23.0	23.2	22.9
Sub-Saharan Africa	20.9	19.7	17.0	17.2	17.9	18.9	18.3	17.9	17.5
Newly-industrialized countries	32.4	29.6	28.8	28.7	26.3	25.3	26.9	28.1	28.9
Heavily-indebted countries	24.7	22.4	17.9	16.2	16.9	17.6	19.0	19.2	18.8
Eastern Europe1	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

Source: International Monetary Fund, and, for Eastern Europe, U.S. Government Sources and Authors' calculations.
 1/ Includes Yugoslavia but excludes the USSR.
 N.A. = Not available.

The NIC's are most often cited as the 1980's success stories. They had average per capita growth rates of 6.7 percent in the 1970's, and *positive* per capita income growth averaging 5.9 percent during 1981-84. The average per capita increase in 1985-89 was over 8 percent. One difference between the NIC's and the highly indebted countries, as noted earlier, was the success of export promotion policies in the NIC's. Another difference between these two sets of countries is the rate of capital formation.

The heavily indebted countries invested nearly 25 percent of GDP during the 1970's. However, the cutoff in credit to these countries, accompanied by the burden of servicing existing debt, led to declines in gross capital formation—less than 17 percent of national income in 1984 and 1985, and an average of only 18 percent in 1986-89 (table L-2).

In Eastern Europe (excluding the USSR) gross investment declined from 10.3 percent in the early 1970's to -3.7 percent in 1979-82, and then increased only 3.3 percent in the late 1980's, eroding infrastructure and trade earning capacity.

The NIC's, on the other hand, have maintained the investment share of a rapidly growing GDP, nearly 30 percent during the 1980's—only slightly less than their average for the decade of the 1970's. The heavily indebted countries have had three types of investment problems: capital flight, inflation, and dependence on foreign borrowing.

The highly indebted countries tended to be more dependent on foreign capital for investment purposes, partially the result of lower levels of saving than the nondebt-affected major borrowers (1). Therefore, as credit was withdrawn from these countries, investment necessarily declined. Further, increased current national income, which results from

higher capital formation, has not materialized. Finally, future income growth will be less than otherwise.

Rapid increases in domestic prices have been a result of some debtor countries trying to repay debt. Creditors must be paid with foreign currency earned from exports. Encouraging exports led many countries to devalue their currencies. These devaluations meant that the domestic currency cost of repayment rises. Thus, the only solution seemed to be to print money at faster rates, which inevitably leads to higher inflation.

A country's government has two domestic options to service debt: it may borrow money from the public, or print money. Borrowing from the public entails selling government bonds, which would most likely be purchased only at a steep discount. The option is, therefore, to either sell government "junk" bonds (as Sachs puts it (5)), or print money. The latter solution is generally regarded as a more certain way to raise revenue. The central bank will sell foreign exchange at the price dictated by the government, but the public may not wish to buy government bonds, regardless of the rate of return.

Consumer prices in heavily indebted countries rose, on average, by more than 35 percent per year during the 1970's. This rate of increase accelerated to 77.4 percent in 1986, 116.6 percent in 1987, almost 250 percent in 1988, and over 350 percent in 1989 (table L-2).

A high inflation rate discourages direct investment. People will use potentially investable assets to protect themselves from inflation rather than in creating income-earning assets. The more rapid the rate of inflation, the less desirable is long-term investment.

One way in which people also attempt to evade inflation is by investing abroad. This is known as capital flight. According to one estimate (6), assets of the residents of heavily indebted LDC's held overseas (as of 1987) amounted to \$295 billion dollars, compared with \$223.5 billion in publicly guaranteed debt. Thus, the sources of investment should not be a problem. Bringing the "flight capital" home could effectively substitute for the withdrawal of credit by commercial banks. This, of course, excludes the Eastern European countries whose residents had no access to hard currencies and whose governments control very strictly all capital movements. The LDC's, however, who seek to repatriate flight capital should provide those individuals holding overseas assets the same (or better) rate of return at home as they earn abroad. But, in many cases these assets are held abroad to conceal their existence from government authorities—not because of better earnings opportunities. These funds, therefore, cannot be considered as a source of domestic investment.

The consequence of most immediate importance to the United States is the outlook for U.S. exports to the LDC's and Eastern Europe. Debt-servicing requirements forced these countries to reduce imports and increase exports. The growth in export volume for the most heavily indebted countries, especially since 1983, has been impressive (table L-3). However, export prices remain well below levels of 1980, despite increases in 1987-89. The pressure has therefore fallen on curtailing imports. The volume of imports fell by 40 percent between 1981 and 1985, increasing slowly thereafter.

The contrast with the NIC's could not be more stark. Total imports of these relatively small countries were \$95 billion in 1981, but had risen to \$110 by 1986, and \$195 billion in 1988. Expanding exports have provided the resources to service debt and to pay for more imports of goods and services.

Resolution of the Debt Problem

The preferred world scenario in the early 1980's for the resolution of the debt crisis would include two conditions: There would be a period in which heavily indebted countries would undertake policy changes to realign their export-import balance, and the greater emphasis on exports would be encouraged by a growing world economy.

The first part of the scenario, that of an expanding world trading sector, has been largely realized. Real trade growth has exceeded GDP growth since 1985 (2). Imports by the industrial countries alone rose over 7 percent in 1989 over 1988. Countries with the greatest increases were Japan (11.3 percent), Canada (8.4 percent), and the United States (7.7 percent).

The second part of the adjustment scenario—policy reform in the developing and heavily indebted countries—proved overly optimistic. Inward orientation tended to encourage the establishment of an inefficient industrial structure, underinvestment in the more internationally competitive sectors (including agriculture), and underinvestment in the public sector (physical infrastructure, education), while encouraging inefficient investment in public enterprise.

Table L-3--Trade indicators for selected groups of developing countries and Eastern Europe.

Item	1981	1982	1983	1984	1985	1986	1987	1988	1989
Percent Change									
Volume of exports									
Developing Countries	-5.5	-6.6	1.6	7.0	0.7	8.8	11.2	10.9	6.6
Sub-Saharan Africa	-2.1	1.4	1.4	5.2	0.3	7.8	4.0	-2.9	6.2
Newly-industrialized countries	10.4	2.5	14.5	16.1	4.1	20.7	23.2	14.1	10.8
Heavily-indebted countries	-0.8	-5.0	5.6	8.7	1.5	-1.8	6.1	8.7	3.0
Eastern Europe 1/	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Volume of imports									
Developing Countries	8.0	-3.4	-2.8	2.6	-0.6	-4.4	5.7	10.2	8.7
Sub-Saharan Africa	0.1	-4.8	-7.9	-0.7	0.2	-2.0	-0.5	2.5	0.8
Newly-industrialized countries	6.4	1.4	8.0	10.0	-0.1	10.5	25.2	20.2	15.9
Heavily-indebted countries	3.1	-16.3	-21.3	-2.2	1.4	-1.0	0.3	5.4	2.9
Eastern Europe 1/	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Export prices									
Developing Countries	4.1	-4.8	-6.9	-0.7	-5.0	-14.5	10.0	2.8	4.4
Sub-Saharan Africa	-8.5	-8.0	-2.2	3.8	-3.7	-6.0	1.7	4.2	-1.1
Newly-industrialized countries	2.5	-4.1	-4.6	2.0	-2.9	-0.7	9.3	8.7	5.3
Heavily-indebted countries	0.1	-7.0	-6.3	2.2	-4.7	-14.7	6.9	4.0	4.4
Eastern Europe 1/	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Billions of current dollars									
Current account balance									
Developing Countries	-43.3	-77.1	-57.6	-27.5	-21.8	-41.3	4.1	-9.1	-7.3
Sub-Saharan Africa	-9.6	-8.2	-5.6	-3.3	3.3	-5.8	-6.5	-8.1	-6.8
Newly-industrialized countries	-7.2	-2.8	1.6	6.6	10.2	23.2	30.3	27.8	26.1
Heavily-indebted countries	-50.4	-50.8	-15.3	-1.5	-0.2	-17.2	-9.0	-9.8	-8.9
Eastern Europe	-7.8	0.6	3.8	5.2	2.0	-0.4	-0.2	4.9	N.A.

Source: International Monetary Fund, and, for Eastern Europe, United Nations.

1/ Includes Yugoslavia but excludes the USSR.

N.A. = Not available.

Debt repayment and the withdrawal of credit forced a superficial policy "liberalization" in many countries, while not correcting serious internal problems, such as inflation. Under these conditions, debt repayment has proved sustainable only with a decline in real income. Declines in real income were borne mainly by the poorest segments of the economies. This widened already wide disparities in income distribution, particularly in Latin America.

Generally, inflation rewarded entrenched interests in the heavily subsidized public sectors at the expense of areas badly needing reform. That is, inflation rewards those with readily available skills and products to sell. Those without skills, or without the ability to sell their skills, have suffered. Thus, state-supported enterprises and bureaucracies flourish, while other areas await needed improvement.

Structural adjustments may be required, in the long run, to redirect public investment and to realign the inefficient industrial structure toward more fully utilizing the resources of individual economies. In Eastern Europe, particularly Poland, this has already occurred in the form of a dramatic shift from centrally planned, autarkic systems to nearly open capitalistic systems based on private enterprise and reintegration into the world market.

Czechoslovakia and Hungary are proceeding in the same direction, albeit more cautiously. East Germany's debt problems will be largely resolved in reunification with West Germany. Recent changes in governments in Latin America, particularly in Argentina, Brazil, Chile, and Peru, may result in changes similar to those seen in Czechoslovakia and Hungary.

Solutions and Signs of Potential Success

Given the above, viable solutions come down to one "bottom line:" the current debt burden must be reduced while, at the same time, new sources of financing for investment are made available. Repayment schedules would be more in line with ability to pay, and capital could be developed.

It is generally agreed that this "bottom line" will not be successful unless more outward-looking policies are adopted. That is, commercial financing will not be provided unless heavily indebted countries become creditworthy. This implies both "bankruptcy", which reduces debt, and "new management" (drastic reform of the economic system).

The problem of "new management" may yet be solved, as in Eastern Europe and the democratic movements in Argentina, Brazil, and Chile. The question is then one of how to reach an agreement among interested parties concerning the distribution of diminished assets. Bankers must agree to reduced payments, and debtors must provide stronger guarantees of future performance. Much of the problem in reaching

mutual agreement can be identified as incompatible incentives for these two events to occur.

High "debt overhang" can reduce economic efficiency in two ways (6). First, high debt-service payments may require high tax rates, either explicitly, on capital, or implicitly, on export earnings, both of which encourage capital flight (4). Second, high current repayments may frustrate attempts at policy reform by producing inflation, another tax which limits the ability of fiscal policy to effect change.

The failure of the rescheduling process has, according to some, indicted the whole voluntary approach to debt reduction. One solution calls for an international institution devoted to debt reduction (3). The argument is that such an institution, can effectively eliminate the debt "overhang" in two ways. First, it will guarantee payment of a reduced portion of outstanding debt to commercial banks. Second, it will enforce, through provision of new financing, policy reforms in the heavily indebted countries. However, a new institution may face additional problems of its own.

The first problem is one of commercial bank participation. Sufficient relief, such that a portion of debt may be serviced, could lead some banks to avoid participation; the value of the debt they hold will rise as the other obligations of heavily indebted countries fall. Thus, the banks that sign on first will lose the most. The solutions would be to either subordinate old debt or to coerce banks into participation. Either may prove difficult to implement.

The second problem with an international institution is that "automatic" debt relief, or the appearance of such, could lead to overborrowing. Governments would have little incentive to limit borrowing to their ability to repay.

A third problem is determining the price at which an international institution would purchase debt. The secondary market provides one potential guide, but prices would almost certainly rise in anticipation of any sort of mandated purchase. Also, the secondary market may not represent all the debt for any one country, but the least collectible of several obligations.

It may be argued that a well-intentioned intermediary may hinder the achievement of a debt-reduction agreement. A bank may enter negotiations with a debtor country by asking for, say, 50 cents on the dollar, while the country itself may offer 40. The two may then agree, if of equal bargaining strength, on a payment of 45 cents. However, the presence of intermediation may distort the process. The bank may see the possibility of receiving a higher payment if the country stands to receive, for example, World Bank financing. Thus, it may set its price at 60 cents. The country, however, may anticipate receiving a World Bank loan, making immediate debt reduction less necessary. It may then offer only 30 cents. The sides may then move too far apart to reach a voluntary settlement.

Voluntary solutions also have their difficulties. Among widely touted voluntary alternatives are debt-equity swaps, debt buybacks, and exit bonds.

Debt-equity swaps have proved popular in Chile, where they have been used with some success (11). The creditor trades a current obligation, at a discount, for domestic currency which is used to purchase an ownership right to a debtor country industry. Chile has seen, as a result, some increase in investment and a sharp decline in debt and debt service payments. These debt-equity swaps do have detractors, however. Debt-equity swaps may be inflationary if used too frequently, since they require the issue of domestic currency, expanding the money supply.

Debt buybacks appear, on the surface, to offer an attractive and quick way to reduce debt. A country buys its debt, often at a steep discount, on the secondary market. However, paradoxically, the market valuation of the debt may not change. The case of Bolivia is instructive. In March 1988, its debt listed for approximately 6 cents per dollar in secondary markets. Bolivia was able to purchase \$308 million (out of a total of \$670 million owed) for \$34 million, a price of about 11 cents on the dollar. Its remaining debt after the purchase (\$362 million) listed at a price of 11 cents. Thus, Bolivia spent \$34 million (much of it donated (11)) to reduce the market value of its debt by only \$400,000.

Debt buybacks have been very little used, because the price of the debt reflects the probable amount of total repayment. This total amount may not change with a buyback. The market price of debt for Bolivia, before and after the buyback, suggests the present value of the repayments remained vitally the same. Chile, Costa Rica, the Philippines, and Mexico have repurchased debt in limited amounts.

The use of "exit bonds" is a substitution of new debt for old. It requires the disbursement of new loans, which are then used to purchase old debt at reduced prices (such as in the secondary market) or available at lower interest rates. These "exit bonds" must offer a higher likelihood of repayment than old debt to attract sponsors. This presents a paradox: those holding old debt may not agree to subordination, and those offering new loans may not do so unless they are guaranteed payment.

The end result, as with the success of the recent U.S. initiative with Mexico, is that a combination of different schemes with voluntary and public aspects may be used. A new money package was negotiated along with interest and principal reduction. Some old debt was exchanged for fully collateralized debt (in the form of a U.S. zero-coupon Treasury Bill). This creative plan is unlikely to be duplicated exactly in other countries, but does point to the fact that solutions, albeit flexible and country-specific, do exist. However, the complexity of the process and the number of actors explains why solutions have been slow in coming.

Conclusions

In spite of all these difficulties, solutions which truly reduce the burden of debt have only just begun to be implemented. Perhaps this is because of the difficulty in accurately assessing the prolonged nature of this problem. The possibility of debt for equity swaps, and the development of a secondary market for Third World debt are elements of a solution. The recent participation of the U.S. Treasury in an innovative mechanism for writing down Mexican debt is another.

The prospect that financial institutions are now more willing to voluntarily consider writedowns and writeoffs of parts of LDC debt is further made credible by the fact that the exposure of the commercial banks is now so much less than it was in 1982.

All these recent developments indicate significant steps toward reducing the financial constraint on trade may be forthcoming. Yet institutional development for facilitating the process are still lacking. However, serious negotiations are still ahead on how the costs of writedowns will be shared between the indebted countries, developed countries and financial institutions. The success of these negotiations will determine whether seriously debt-impacted countries will have a new opportunity to initiate sustained development and trade growth.

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Summing Up: Forces for Change in the 1990's Mean Uncertainties for Agricultural Markets

by
John C. Dunmore*

The growth and pattern of world trade generally measure the state of the world economy. The volume of world agricultural trade as measured by total imports grew at about 2.5 percent per year during the 1960's. Over the decade of the 1970's, the average annual growth rate jumped to nearly 4 percent. The first half of the 1980's, marked by global recession, saw the growth rate fall to about 1.5 percent per year, with 3 of the 5 years recording virtually no growth. The latter part of the 1980's indicates a rebound in growth which, if sustained into the 1990's, could potentially match that of the 1970's.

A comparison of growth in agricultural imports among economic groupings of countries shows little difference between the paths of the developed and developing countries in the early 1970's. Trade patterns changed dramatically by the mid-1970's, however, with growth rates for the developing countries 2-10 times greater than for the developed markets. The centrally planned economies also demonstrated strong, but sporadic, growth over the decade of the 1970's.

A group of about 50 developing countries, classified as middle-income, accounted for virtually all of the growth in developing-country imports over the 1970's, although they account for only about one-third of the developing countries' population. Countries with more rapid economic growth generally increase their agricultural imports at a faster pace than countries with slower growth. Rising incomes support a diversification of diets and create a growth in food demand that eventually outpaces agricultural production. That is essentially the story behind the 1970's phenomenal growth in world agricultural trade.

The increased dependence of the middle-income countries on trade to meet domestic food requirements was due not to declining production, but to rising consumption on the basis of increases in per capita income.

Factors for Change in the 1990's

Looking back, the factors responsible for growth in world agricultural markets in the 1970's seemed simple and basic. But, as is often the case whenever attempting to look ahead, the future seems clouded with uncertainties—there are many factors for change that could influence market prospects.

So it is as we look to the 1990's. The historical patterns of trade growth would imply that any look ahead to prospects for agricultural markets should obviously focus on the middle-income developing countries. But there are other, significant forces for change in the 1990's that could bring greater opportunities or tighter constraints for market prospects. Among those discussed in this issue are:

- Ongoing political and economic reforms in Eastern Europe and the USSR, and to a more uncertain degree in China.
- Accelerated integration of the European Community (EC).
- Slow but significant change in the Japanese food processing industry and pressures for economic integration in the Pacific Rim.
- Uncertain prospects for trade reform under the current Uruguay Round of multilateral negotiations.
- Food safety, which has emerged as a new and contentious issue challenging negotiators.
- Forces for strengthening the General Agreement on Tariffs and Trade (GATT), but countering forces leading to proliferation of bilateral and preferential trading arrangements (PTA's).

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- A third-world and East European debt problem which has developed into a growth crisis, threatening to further widen the gap between the “haves” and the “have-nots.”
- The transition of formerly centrally planned economies from nonconvertible to convertible currencies.

These forces for change make prospects for world agricultural markets in the 1990's more uncertain than probably was the case at the beginning of any decade in the recent past.

Change in the Major Actors

In the developed countries, integration of the EC's internal market implies increased opportunities as well as prospects for greater competition for those looking to do business in Europe. Japan may provide more market growth potential than many expect. The structure of Japanese agricultural imports continues to change, with value-added imports now almost as important as bulk commodity imports. Changes in Japan are likely to continue as a result of already agreed-to reductions in trade barriers, rising consumer incomes, and a “Westernization” of diets.

In Eastern Europe and the USSR, trends and composition of agricultural trade can also be expected to change over the 1990's. The ability to import is obviously tied to the ability to export. In Eastern Europe, agricultural exports appear to offer the greatest potential to generate hard-currency earnings. Improved efficiencies and enhanced producer incentives could bring a positive change on the supply-side of the ledger. However, price increases and the removal of food subsidies could also have a demand-dampening impact. On a net basis, economic and policy reform could result in greater self-sufficiency and a potential decline in imports of basic foodstuffs, at least in the initial stages.

Key to the role played by Eastern Europe and the USSR in agricultural import markets of the 1990's will be their ability to export (to earn foreign exchange) and compete in world markets. Full-fledged entry into world markets is preconditioned on currency convertibility, which, for the USSR at least, may not come about in the 1990's.

In China, which recorded much higher rates of economic growth in the 1980's than either Eastern Europe or the USSR, agricultural imports are expected to continue to expand into the 1990's. Domestic demand continues to increase, while staple grain and oilseed production has been leveling off. An increase, albeit slow, in grain imports is expected over the 1990's.

There will continue to be compositional changes in agricultural imports of the developed and (present or former) centrally planned countries. But, those countries/regions will

not likely provide a basis for strong growth in the volume of agricultural trade in the 1990's. The middle-income developing countries have been, and will likely continue to be, the basis for market growth potential for food and agricultural products through the next decade.

Change in the Developing Countries

The economic forces at work in the early 1980's tended to undercut the world market in a key area—participation. The economic growth of the 1970's, combined with easy credit and a weakened U.S. dollar, allowed many of the middle-income developing and many less affluent developed and centrally planned countries to buy into the world market at an accelerated pace of “participation.”

With the slowdown in the world economy in the 1980's, serious debt problems emerged among a number of developing and East European countries, many of which were large markets for agricultural exports from the United States and elsewhere.

In the mid-1980's, all of the countries classified as “highly indebted” fell in the middle-income countries category. This is significant in that these highly-indebted countries represented roughly one-half of the population and gross national product (GNP) of the middle-income countries. Thus, the debt problem and the inability of the debt-affected countries to substantially increase trade participation remains a major area of uncertainty and a potentially serious constraint to agricultural market growth in the 1990's.

For many of the developing countries, the debt crisis has become a growth crisis as well. Facing a severe shortage of hard currencies resulting from their heavy debt servicing burden and lower export earnings, many debtor countries have drastically cut down on imports of capital goods, as well as food imports. The potential for strong, long-term economic growth in the problem debtor countries in Latin America, Africa, and Asia, has been severely curtailed.

Because the level of trade in agricultural products is strongly tied to the overall path of growth in economic activity, the diverging growth paths, and the widening income gap, between the developed and the developing countries brings another element of uncertainty to market growth prospects for the 1990's.

Change in the Structure and Performance of World Markets

How are the structure and performance of the world trade system likely to be affected by these forces for change?

In the early 1980's, growth in global production rebounded because of expanded investment in the agricultural sectors of many countries, particularly developed countries. In addition, a sharp drop in consumption growth accompanied a

worldwide slowdown in economic growth. As agricultural trade grew more slowly and excess capacity in global agriculture grew more rapidly, nations tried to protect their farmers and, in some cases, their market shares by more intense individual or collective government intervention in the marketing process.

The magnitude and types of government intervention were not all new to the 1980's. Insulating agricultural markets from world markets—breaking the link between world price movements and domestic prices—was already occurring in the 1970's.

During that decade, protection under the EC's Common Agricultural Policy was extended to the United Kingdom, Ireland, and Denmark as that preferential trading bloc was enlarged. In addition, the centrally planned countries, particularly major state traders like the USSR, whose domestic markets were thought to be highly insulated from the world market, were becoming larger players in selected world commodity markets. A large number of international commodity agreements (ICA's) were also in various states of operation and/or re-negotiation. Many ICA's were attempting to stabilize and regulate prices and markets, thereby stifling competitive inclinations. In the upbeat market of the 1970's, however, this move toward greater insulation of markets went largely unnoticed.

Agricultural policies that were started or strengthened in many leading countries in the 1970's put additional pressure on the falling commodity prices and declining world trade levels of the 1980's. These policies, and the trading practices employed to defend them, added an extra element of risk and uncertainty for those countries who were becoming increasingly dependent on trade. More frequent confrontations over the use of protective agricultural policies, and the associated effects on market stability, seems to have generated a move away from dependence on trade that threatens to offset the gains made during much of the postwar period.

A major force for change, and one which probably holds the greatest uncertainty for market growth prospects, is the rising level of trade protection/insulation and attempts to stem that tide in the current multilateral trade talks underway in the GATT. From an operational context, will the world trading environment be a more open and comprehensive GATT system? Or will the trend toward increasing insulation continue?

Commodity agreements have proven over time to have limited effectiveness and attempts to regulate and control global

markets through ICA's is, for the most part, past. However, while attempts to manage or control markets along commodity lines has failed, there is a readily observable trend, and ever increasing rhetoric, toward expanding bilateral and regional trade arrangements.

Preferential trading arrangements (PTA's) can be discriminatory, and limit market access to those countries outside the PTA. The proliferation of PTA's, a potential by-product of an unsuccessful Uruguay Round, could have adverse effects for the operation of world markets and for a U.S. agricultural sector increasingly dependent on open markets.

The current GATT negotiations on agriculture in the area of sanitary/phytosanitary measures are also important as the EC moves ahead with harmonization of its food safety regulations and standards. Success in this area could prevent greater divergence in food safety regulations and a tendency to use food safety regulations as trade barriers.

From a broader operational context, much depends on the outcome of the Uruguay Round of multilateral trade negotiations, and on whether significant progress can be made on the more contentious issues, including agriculture. Many countries, including the United States, have stated that they will only accept a comprehensive package that includes reforms in all sectors. Thus, a successful agreement on agriculture may be a prerequisite for a successful Round, and for a strengthened and operationally efficient world trade system.

Conclusion

The global economy will see significant institutional and structural change over the 1990's. These changes hold important implications for world agricultural markets. Whether these changes hold the promise of an expanded world market for agricultural products, or the peril of more insulated and more restrictive markets depends on the pace of reform in the centrally planned economies and the nature of a more fully integrated European market. But, more importantly, the outcome for world markets is dependent on finding workable solutions to the debt/growth problems in developing countries and to a successful GATT Round.

Successfully weathered, these trade protection and debt/growth pressures could result in a stronger world market serving both importer and exporter needs better. Unresolved, however, these pressures could result in a weakening of the world market and bring with it dramatically slower growth in world agricultural trade.

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